

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Campbell Analyst: Jeff Garnier Bill Number: AB 1743  
Related Bills: See Legislative History Telephone: 845-5322 Amended Date: 1/7/02 & 1/29/02  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Conformity to Portions of 2001 Economic Growth & Tax Relief Reconciliation Act (EGTRRA)

### SUMMARY

This bill would conform state law to the following changes contained in the federal Economic Growth & Tax Relief Reconciliation Act (EGTRRA):

- pension plans,
- two retirement related credits,
- Education IRA (Coverdell Education Saving Account or Coverdell Account), and
- Qualified Tuition Plan.

### SUMMARY OF AMENDMENTS

The January 29, 2002, amendments added the Qualified Tuition Plan conformity provisions to the bill.

### PURPOSE OF THE BILL

The author's staff has indicated that the purpose of the bill is to conform to the recent federal changes to pension plans, Coverdell Accounts, two new retirement related credits, and Qualified Tuition Plans, thus permitting greater financial freedom to many Californians.

### EFFECTIVE/OPERATIVE DATE

This bill is a tax levy. Thus, it would be effective immediately, and unless otherwise specified, it would apply to the same periods as the federal provisions, generally for taxable years beginning on or after January 1, 2002 and before January 1, 2011.

### POSITION

On March 6, 2002, the Franchise Tax Board voted 2-0 to support the bill if it is amended to exclude the two retirement related credits.

### ANALYSIS

Prior to June of 2001, California law was generally in conformity with the federal pension plan, education savings account (the name later changed to Coverdell Accounts), and Qualified State Tuition Plan provisions. These federal provisions were changed by the EGTRRA. The federal changes generally enhanced the benefits and eased the administration of pension plans, Coverdell Accounts, and Qualified Tuition Plans. EGTRRA also created two new credits related to retirement. California, however, has not conformed to the EGTRRA provisions affecting pension plans, Coverdell Accounts, the two new retirement related credits, and Qualified Tuition Plans.

#### Board Position:

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#### Department Director

#### Date

Gerald H. Goldberg

03/08/02

The following is a summary of the 2001 federal changes to pension plans, two retirement related credits, Coverdell Accounts, and Qualified Tuition Plan provisions that would be conformed to by this bill. The section numbers are references to the section of the EGTRRA. A complete explanation of the pension plan, Coverdell Account, and Qualified Tuition Plan federal and state laws affected by this bill is attached as **Appendix I**<sup>1</sup>.

**Sec. 401. Modifications to education individual retirement accounts.** Increases, from \$500 to \$2,000, the annual limit on contributions to education IRAs (aka Coverdell education savings account). Increases, on a joint return, the phase out so that it is twice that of a taxpayer filing a single return. Includes expenditures for qualified elementary and secondary education as qualified education expenses. Waives age limitations for special needs children. Permits corporations to contribute to education IRAs. Permits annual contributions to be made until the filing date (not including extensions) for a tax year. Extends the time for return of excess contributions. Provides for coordination of the Hope credit, Lifetime Learning credit, and qualified tuition program provisions.

**Sec. 402. Modifications to qualified tuition programs.** Permits an eligible educational institution (currently, limited to a state or agency or instrumentality thereof) to maintain a qualified tuition program, provided such program has received a ruling that such program meets the applicable requirements for a qualified tuition program. Excludes from gross income education distributions from qualified tuition programs. Permits the transfer of credits from one qualified tuition program to another qualified program for the benefit of the same beneficiary without the transfer being considered a distribution. Permits expenses for the special needs services of a special needs beneficiary.

**Sec. 601. Modification of IRA contribution limits.** Increases the Individual Retirement Account (IRA) annual dollar contribution limit to \$3,000 for 2002 through 2004, \$4,000 for 2005 through 2007, and \$5,000 for 2008 and thereafter, with indexing in \$500 increments thereafter. Provides, for individuals age 50 and older, that such limit shall be increased by \$500 for 2002 through 2005 and by \$1,000 for years 2006 and thereafter.

**Sec. 602. Deemed IRAs under employer plans.** Deems certain voluntary employee contributions to accounts and annuities as IRAs rather than pension plans.

**Sec. 611. Increase in benefit and contribution limits.** Increases annual benefit limits to \$160,000 and annual contribution limits to \$40,000. Increases, over five years, the annual contribution limits for 401 (k) and other employer-sponsored plan to \$15,000. Sets indexes for inflation in various increments on such increased limits.

**Sec. 612. Plan loans for subchapter S owners, partners, and sole proprietors.** Revises requirements relating to plan loans for subchapter S owners, partners, and sole proprietors.

**Sec. 613. Modification of top-heavy rules.** Revises specified top-heavy rules. Revises the definition of key employee. Requires that employer-matching contributions be taken into account for purposes of minimum contribution requirements. Provides for distributions during the last year before a determination date is taken into account. Excludes from the definition of top-heavy plan: (1) cash or deferred arrangements using alternative methods of meeting nondiscrimination requirements; and (2) defined contribution plans using alternative methods of meeting nondiscrimination requirements.

**Sec. 614. Elective deferrals.** Provides that elective deferrals shall not be taken into account for purposes of limits on certain plan contributions.

**Sec. 615. Deferred compensation plans of state and local governments and tax-exempt organizations.** Repeals specified coordination requirements for deferred compensation plans of state and local governments and tax-exempt organization.

**Sec. 616. Deduction limits.** Revises certain deduction limits for stock bonus and profit sharing trusts and for defined contribution plans.

**Sec. 617. Option to treat elective deferrals as after-tax Roth contributions.** Provides for optional treatment of elective deferrals as Roth contributions.

**Sec. 618. Nonrefundable credit to certain individuals for elective deferrals and IRA contributions.** Allows an individual a tax credit of up to \$1,000 (50% of contributions up to \$2,000 for low- and middle-income taxpayers) for qualified retirement savings contributions.

<sup>1</sup> Information for Appendix I derived from the Conference Report for EGTRRA, House Report 107-84.

**Sec. 619. Credit for pension plan startup costs of small employers.** Allows an eligible small employer a pension plan startup cost credit of up to \$500 (maximum 50% of the first \$1,000 spent) for each of the first three years.

**Sec. 631. Catch-up contributions for individuals age 50 or over.** Allows individuals who are age 50 or older to make additional contributions to an applicable employer plan.

**Sec. 632. Equitable treatment for contributions of employees to defined contribution plans.** Sets forth requirements relating to equitable treatment for contributions of employees to defined contribution plans. Increases the 25 percent of compensation limitation on annual additions under a defined contribution plan to 100 percent. Declares that certain contributions by church plans are not to be treated as exceeding a specified limit. Increases the 33 and one-third percent of compensation limitation on deferrals under deferred compensation plans of state and local governments and tax-exempt entities (section 457 plans) to 100 percent of compensation.

**Sec. 633. Faster vesting of certain employer matching contributions.** Provides for faster vesting of certain employer matching contributions.

**Sec. 634. Modification to minimum distribution rules.** Provides for the modification of the life expectancy tables concerning the minimum distribution rules.

**Sec. 635. Clarification of tax treatment of division of section 457 plan benefits upon divorce.** Revises requirements relating to tax treatment of division of section 457 plan benefits upon divorce. Applies the taxation rules for qualified plan distributions pursuant to a qualified domestic relations order to distributions made pursuant to a domestic relations order from a section 457 plan. Provides that a section 457 plan is not to be treated as violating the restrictions on distributions from such plans due to payments to an alternate payee under a qualified domestic relations order.

**Sec. 636. Provisions relating to hardship distributions.** Directs the Secretary to reduce from 12 months to six months the safe harbor relief period during which an employee is prohibited from making elective contributions and employee contributions in order for a distribution to be deemed necessary to satisfy a hardship financial need. Provides that a hardship distribution from any qualified plan is not an eligible rollover distribution.

**Sec. 637. Waiver of tax on nondeductible contributions for domestic or similar workers.** Provides for a waiver of tax on certain nondeductible contributions made for pension coverage for domestic or similar workers, by providing that the ten-percent excise tax on nondeductible contributions does not apply to contributions to a SIMPLE 401(k) plan or SIMPLE IRA that are nondeductible solely because they are not made in connection with a trade or business of the employer. Declares that nothing in such amendment shall be construed to infer the proper treatment of nondeductible contributions under the laws in effect before such amendment.

**Sec. 641. Rollovers allowed among various types of plans.** Permits rollovers from and to various types of plans under the Code.

**Sec. 642. Rollovers of IRAs into workplace retirement plans.** Permits individual retirement plan (IRA) rollovers into workplace retirement plans only if certain conditions are met.

**Sec. 643. Rollovers of after-tax contributions.** Sets forth a hardship exception to the 60-day rule. Authorizes the Secretary to waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.

**Sec. 644. Hardship exception to 60-day rule.** Sets forth a hardship exception to the 60-day rule. Authorizes the Secretary to waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.

**Sec. 645. Treatment of forms of distribution.** Sets forth requirements for treatment of forms of distribution available under transferor and transferee plans under the Code.

**Sec. 646. Rationalization of restrictions on distributions.** Revises restrictions on distributions, including the same desk exception. Repeals business sale requirements.

**Sec. 647. Purchase of service credit in governmental defined benefit plans.** Authorizes trustee-to-trustee transfers to purchase permissive service credit with respect to governmental defined benefit plans.

**Sec. 648. Employers may disregard rollovers for purposes of cash-out amounts.** Allows employers to disregard rollovers for purposes of cash-out amounts, under retirement plan provisions of the Code.

**Sec. 649. Minimum distribution and inclusion requirements for section 457 plans.** Revises minimum distribution and inclusion requirements for section 457 plans.

**Sec. 651. Repeal of 160 percent of current liability funding limit.** Increases, until repeal (2004), the current liability full funding limit.

**Sec. 652. Maximum contribution deduction rules modified and applied to all defined benefit plans.** Revises maximum contribution deduction rules. Applies such rules to all defined benefit plans.

**Sec. 654. Treatment of multi-employer plans under section 415.** Makes limitation rules on benefits and contributions for qualified benefit plans (section 415 plans) inapplicable to governmental or multi-employer plans. Sets forth special rules relating to the combination or aggregation of multi-employer plans

**Sec. 655. Protection of investment of employee contributions to 401(k) plans.** Modifies the effective date of the rule excluding certain effective date deferrals from the definition of individual account plan

**Sec. 656. Prohibited allocations of stock in S corporation ESOP.** Requires any employee stock ownership plan (ESOP) holding employer securities consisting of stock in an S corporation to provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such employer securities may, during a nonallocation year, accrue (or be allocated directly or indirectly under any qualified plan of the employer) for the benefit of any disqualified person. Defines a nonallocation year as any ESOP plan year if, at any time during it such plan holds employer securities consisting of stock in an S corporation, and disqualified persons own at least 50 percent of the number of shares of stock in that corporation. Prescribes attribution rules. Imposes an excise tax for violations of such prohibition.

**Sec. 657. Automatic rollovers of certain mandatory distributions.** Makes a direct rollover the default option for mandatory distributions exceeding \$1,000 and that are eligible rollover distributions from qualified retirement plans.

**Sec. 658. Clarification of treatment of contributions to multi-employer plan.** States that a determination regarding the taxable year with respect to which a contribution to a multi-employer pension plan is deemed made shall not be treated as a method of accounting.

**Sec. 661. Modification of timing of plan valuations.** Revises requirements relating to timing of plan valuations.

**Sec. 662. ESOP dividends may be reinvested without loss of dividend deduction.** Allows applicable dividends of ESOPs to be reinvested without loss of dividend deduction.

**Sec. 663. Repeal of transition rule relating to certain highly compensated employees.** Repeals a transition rule relating to certain highly compensated employees under the Tax Reform Act of 1986.

**Sec. 664. Employees of tax-exempt entities.** Directs the Secretary to modify certain regulations with respect to certain plan participation by employees of tax-exempt entities.

**Sec. 665. Clarification of treatment of employer-provided retirement advice.** Excludes from gross income any fringe benefit qualifying as a qualified retirement planning service.

**Sec. 666. Repeal of the multiple use test.** Repeals the multiple use test, and directs the Secretary to prescribe regulations, as necessary, including ones permitting appropriate aggregation of plans and contributions.

## THIS BILL

**This bill** would conform California tax law to the above-listed provisions of the EGTRRA.

All the changes made by the EGTRRA sunset on December 31, 2010. By referencing federal law, the provisions of **this bill** would also sunset on the same date.

## POLICY CONSIDERATIONS

This bill would allow a credit equal to 100% of the amount of the two new federal credits relating to retirement created in EGTRRA (credit to certain individuals for elective deferrals and IRA contributions, and section 619, relating to a credit for pension plan startup costs of small employers.) Generally, when California conforms to a federal credit, only a percentage of the federal amount is allowed as a state credit.

Additionally, both federal credits can be for 50% of the amount of the expense incurred, therefore, coupled with the credits proposed in this bill, the taxpayer could receive a credit for 100% expense. The department has found that credits in an amount equal to or in excess of the incurred costs have the potential to lead to abuse because the taxpayer is not at risk for the activity that generates the credit. The author's staff has indicated that the bill will be amended to conform to a percentage of the two federal credits..

### IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

### **LEGISLATIVE HISTORY**

AB 1122 (Corbett, 2001/2002) contains the same provisions as this bill, except that AB 1122 would not conform to the two new federal retirement related credits. AB 1122 also contains numerous other federal conformity provisions. Presently, AB 1122 is in the Senate Revenue and Taxation Committee.

AB 1744 (Corbett, 2001/2002) conforms to two provisions of EGTRRA, Act Sections 641 and 647, relating to certain IRC Section 457 changes. AB 1744 is in the Assembly Appropriations Committee

SB 657 (Scott, 2001/2002) contains the same EGTRRA and federal election provisions as this bill except that SB 657 would not conform to the EGTRRA changes made to the CDC credit. SB 657 also would not conform to the federal treatment of gifts of appreciated property for AMT purposes and the treatment of estimated tax payments. SB 657 does contain two other conformity provisions not contained in this bill – denial of club dues and excessive employee remuneration in excess of \$1 million dollars. Presently, SB 657 is in the Assembly Appropriations Committee.

SB 1256 (Brulte, 2001/2002) contains the same EGTRRA provisions as this bill. Additionally, SB 1256 would not prevent the disqualification pension plans due to future federal changes in retirement savings. Presently, SB 657 is in the Senate Appropriations Committee.

### **OTHER STATES' INFORMATION**

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. Illinois, New York, and Michigan automatically conform to federal law. Therefore, these states are in conformity with the EGTRRA changes. Florida does not have a personal income tax. Florida's corporation income tax automatically conforms to federal changes. Massachusetts and Minnesota conform to the IRC with a specified date. The construction of Massachusetts law permits qualified federal retirement plans to be qualified under Massachusetts law. Massachusetts has not conformed to the higher deductible or excludible amounts that are allowed under EGTRRA. Minnesota recently passed legislation to conform to EGTRRA.

## FISCAL IMPACT

This bill would not significantly impact the department's costs.

## ECONOMIC IMPACT

### Revenue Estimate

This bill would result in the following conformity revenue losses beginning in 2002-03. Most conformity estimates were based on federal projections developed for the Economic Growth & Tax Relief Reconciliation Act of 2001.

Estimated Conformity Impact of AB 1743 As Amended 1/29/02 [\$ In Millions]			
Provision	2002-03	2003-04	2004-05
Credit to certain individuals for elective deferrals and IRA contributions	-\$85	-\$55	-\$52
Small business tax credit for new retirement plan expenses	-\$1.5	-\$2	-\$3
<u>Coverdell Accounts</u>	----- negligible loss -----		
Qualified tuition plans	minor loss	-\$1	-\$1
IRA provisions	-\$9	-\$9	-\$13
Pension provisions	-\$35	-\$38	-\$45
<b><u>Total</u></b>	<b>-\$130.5</b>	<b>-\$105</b>	<b>-\$114</b>

In addition to the above conformity losses, baseline revenue losses for Coverdell Accounts and IRA and pension provisions total \$40, \$40, and \$60 million for fiscal years 2002-03, 2003-04, and 2004-05 respectively. With respect to Coverdell Accounts and IRAs, baseline losses will result automatically due to the non-reporting for state tax purposes of the inside build-up of earnings for taxpayers taking advantage of the new federal limits. For pension issues, baseline losses will result automatically due to federal ERISA provisions (assuming federal preemption). Not making audit assessments in subsequent years contributes to a significant increase in conformity revenue losses over time. There is no baseline loss relative to expansion of qualified tuition plans.

## LEGISLATIVE STAFF CONTACT

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<u>Section</u>	<u>Section Title</u>
<u>_ 401</u>	MODIFICATIONS TO EDUCATION IRAs.

Background

*In general*

Section 530 of the Code provides tax-exempt status to education individual retirement accounts ("education IRAs"), meaning certain trusts or custodial accounts which are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a designated beneficiary. Contributions to education IRAs may be made only in cash. Special estate and gift tax rules apply to contributions made to and distributions made from education IRAs.

Annual contributions to education IRAs may not exceed \$500 per beneficiary (except in cases involving certain tax-free rollovers, as described below) and may not be made after the designated beneficiary reaches age 18. Specially, IRC Section 530 states that an education IRA is a trust, which among other things cannot accept contributions that would result in aggregate contributions for the taxable year to exceed \$500.

*Phase-out of contribution limit*

The \$500 annual contribution limit for education IRAs is generally phased-out ratably for contributors with modified adjusted gross income (between \$95,000 and \$110,000). The phase-out range for married taxpayers filing a joint return is \$150,000 to \$160,000 of modified adjusted gross income. Individuals with modified adjusted gross income above the phase-out range are not allowed to make contributions to an education IRA established on behalf of any individual.

*Treatment of distributions*

Earnings on contributions to an education IRA generally are subject to tax when withdrawn. However, distributions from an education IRA are excludable from the gross income of the beneficiary to the extent that the distribution does not exceed the "qualified higher education expenses" incurred by the beneficiary during the year the distribution is made.

If the qualified higher education expenses of the beneficiary for the year are less than the total amount of the distribution (i.e., contributions and earnings combined) from an education IRA, then the qualified higher education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. Thus, in such a case, only a portion of the earnings are excludable (i.e., the portion of the earnings based on the ratio that the qualified higher education expenses bear to the total amount of the distribution) and the remaining portion of the earnings is includible in the beneficiary's gross income.

The earnings portion of a distribution from an education IRA that is includible in income is also subject to an additional 10% tax. The 10% additional tax does not apply if a distribution is made on account of the death or disability of the designated beneficiary, or on account of a scholarship received by the designated beneficiary. The additional 10% tax also does not apply to the distribution of any contribution to an education IRA made during the taxable year if such distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the taxable year during which the contribution was made (or, if the beneficiary is not required to file such a return, April 15th of the year following the taxable year during which the contribution was made).

Present law allows tax-free transfers or rollovers of account balances from one education IRA benefiting one beneficiary to another education IRA benefiting another beneficiary (as well as redesignations of the named beneficiary), provided that the new beneficiary is a member of the family of the old beneficiary and is under age 30.

Any balance remaining in an education IRA is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies).

#### *Qualified higher education expenses*

The term "qualified higher education expenses" includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half time, or less than half-time basis. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified state tuition program, as defined in section 529, for the benefit of the beneficiary of the education IRA. Moreover, qualified higher education expenses include, within limits, room and board expenses for any academic period during which the beneficiary is at least a half-time student. Room and board expenses that may be treated as qualified higher education expenses are limited to the minimum room and board allowance applicable to the student in calculating costs of attendance for federal financial aid programs under section 472 of the Higher Education Act of 1965, as in effect on the date of enactment of the Small Business Job Protection Act of 1996 (August 20, 1996). Thus, room and board expenses cannot exceed the following amounts: (1) for a student living at home with parents or guardians, \$1,500 per academic year; (2) for a student living in housing owned or operated by the eligible education institution, the institution's "normal" room and board charge; and (3) for all other students, \$2,500 per academic year.

Qualified higher education expenses generally include only out-of-pocket expenses. Such qualified higher education expenses do not include expenses covered by educational assistance for the benefit of the beneficiary that is excludable from gross income. Thus, total qualified higher education expenses are reduced by scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127.

Present law also provides that if any qualified higher education expenses are taken into account in determining the amount of the exclusion for a distribution from an education IRA, then no deduction (e.g., for trade or business expenses), exclusion (e.g., for interest on education savings bonds) or credit is allowed with respect to such expenses.

Eligible educational institutions are defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

#### *Time for making contributions*

Contributions to an education IRA for a taxable year are taken into account in the taxable year in which they are made.



*Coordination with HOPE and Lifetime Learning credits*

If an exclusion from gross income is allowed for distributions from an education IRA with respect to an individual, then neither the HOPE nor Lifetime Learning credit may be claimed in the same taxable year with respect to the same individual. However, an individual may elect to waive the exclusion with respect to distributions from an education IRA. If such a waiver is made, then the HOPE or Lifetime Learning credit may be claimed with respect to the individual for the taxable year.

*Coordination with qualified tuition programs*

An excise tax is imposed on contributions to an education IRA for a year if contributions are made by anyone to a qualified state tuition program on behalf of the same beneficiary in the same year. The excise tax is equal to 6% of the contributions to the education IRA. The excise tax is imposed each year after the contribution is made, unless the contributions are withdrawn.

New Federal Law (IRC. Sec. 530)

*Annual contribution*

The Act increases the annual limit on contributions to education IRAs from \$500 to \$2,000. Thus, aggregate contributions that may be made by all contributors to one (or more) education IRAs established on behalf of any particular beneficiary is limited to \$2,000 for each year.

*Qualified education expenses*

The Act expands the definition of qualified education expenses that may be paid tax-free from an education IRA to include "qualified elementary and secondary school expenses," meaning expenses for (1) tuition, fees, academic tutoring, special need services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under state law, (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary, and (3) the purchase of any computer technology or equipment (as defined in sec. 170(e)(6)(F)(i)) or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature.

*Phase-out of contribution limit*

The Act increases the phase-out range for married taxpayers filing a joint return so that it is twice the range for single taxpayers. Thus, the phase-out range for married taxpayers filing a joint return is \$190,000 to \$220,000 of modified adjusted gross income.

### *Special needs beneficiaries*

The Act provides that the rule prohibiting contributions to an education IRA after the beneficiary attains 18 does not apply in the case of a special needs beneficiary (as defined by Treasury Department regulations). In addition, a deemed distribution of any balance in an education IRA does not occur when a special needs beneficiary reaches age 30. Finally, the age 30 limitation does not apply in the case of a rollover contribution for the benefit of a special needs beneficiary or a change in beneficiaries to a special needs beneficiary. Treasury regulations are to define a special needs beneficiary to include an individual who because of a physical, mental, or emotional condition (including learning disability) requires additional time to complete his or her education.

### *Contributions by persons other than individuals*

The Act clarifies that corporations and other entities (including tax-exempt organizations) are permitted to make contributions to education IRAs, regardless of the income of the corporation or entity during the year of the contribution.

### *Contributions permitted until April 15*

Under the Act, individual contributors to education IRAs are deemed to have made a contribution on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the individual's federal income tax return for such taxable year (not including extensions). Thus, individual contributors generally may make contributions for a year until April 15 of the following year.

### *Qualified room and board expenses*

The Act modifies the definition of room and board expenses considered to be qualified higher education expenses. This modification is described with the provisions relating to qualified tuition programs, below.

### *Coordination with HOPE and Lifetime Learning credits*

The Act allows a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the contributions and the earnings portions) from an education IRA on behalf of the same student as long as the distribution is not used for the same educational expenses for which a credit was claimed.

### *Coordination with qualified tuition programs*

The Act repeals the excise tax on contributions made by any person to an education IRA on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified state tuition program on behalf of the same beneficiary. If distributions from education IRAs and qualified tuition programs exceed the beneficiary's qualified higher education expenses for the year (after reduction by amounts used in claiming the HOPE or Lifetime Learning credit), the beneficiary is required to allocate the expenses between the distributions to determine the amount includible in income.

### Effective Date

The provisions modifying education IRAs are effective for taxable years beginning after December 31, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the definition of education IRAs. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
402	PRIVATE PREPAID TUITION PROGRAMS; EXCLUSION FROM GROSS INCOME OF EDUCATION DISTRIBUTIONS FROM QUALIFIED TUITION PROGRAMS.

### Background

#### *Law prior to the Act*

Section 529 of the Code provides tax-exempt status to “qualified state tuition programs,” meaning certain programs established and maintained by a state (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account (a “savings account plan”). The term “qualified higher education expenses” generally has the same meaning as does the term for purposes of education IRAs (as described above) and, thus, includes expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution, as well as certain room and board expenses for any period during which the student is at least a half-time student. An “eligible education institution” is defined the same for purposes of education IRAs (described above) and qualified state tuition programs.

No amount is included in the gross income of a contributor to, or a beneficiary of, a qualified state tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary are included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) are included in the contributor's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary. Distributions from qualified state tuition programs are treated as representing a pro-rata share of the contributions and earnings in the account.

A qualified state tuition program is required to provide that purchases or contributions only be made in cash. Contributors and beneficiaries are not allowed to direct the investment of contributions to the program (or earnings thereon). The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified state tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a state or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships.

Special estate and gift tax rules apply to contributions made to and distributions made from qualified state tuition programs.

A transfer of credits (or other amounts) from one account benefiting one designated beneficiary to another account benefiting a different beneficiary is considered a distribution (as is a change in the designated beneficiary of an interest in a qualified state tuition program), unless the beneficiaries are members of the same family. For this purpose, the term "member of the family" means: (1) the spouse of the beneficiary; (2) a son or daughter of the beneficiary or a descendent of either; (3) a stepson or stepdaughter of the beneficiary; (4) a brother, sister, stepbrother or stepsister of the beneficiary; (5) the father or mother of the beneficiary or an ancestor of either; (6) a stepfather or stepmother of the beneficiary; (7) a son or daughter of a brother or sister of the beneficiary; (8) a brother or sister of the father or mother of the beneficiary; (9) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the beneficiary; or (10) the spouse of any person described in (2)-(9). Earnings on an account may be refunded to a contributor or beneficiary, but the state or instrumentality must impose a more than *de minimis* monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, (3) made on account of a scholarship received by the beneficiary, or (4) a rollover distribution.

To the extent that a distribution from a qualified state tuition program is used to pay for qualified tuition and related expenses (as defined in sec. 25A(f)(1)), the beneficiary (or another taxpayer claiming the beneficiary as a dependent) may claim the HOPE credit or Lifetime Learning credit with respect to such tuition and related expenses (assuming that the other requirements for claiming the HOPE credit or Lifetime Learning credit are satisfied and the modified AGI phase-out for those credits does not apply).

### New Federal Law (IRC. Sec. 529)

#### *Qualified tuition program*

The Act expands the definition of "qualified tuition program" to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under section 529 (other than the present-law state sponsorship rule). In the case of a qualified tuition program maintained by one or more private eligible educational institutions, persons are able to purchase tuition credits or certificates on behalf of a designated beneficiary (as set forth in sec. 529(b)(1)(A)(i)), but would not be able to make contributions to a savings account plan (as described in sec. 529(b)(1)(A)(ii)). Except to the extent provided in regulations, a tuition program maintained by a private institution is not treated as qualified unless it has received a ruling or determination from the IRS that the program satisfies applicable requirements.

The Act provides that, in order for a tuition program of a private eligible education institution to be a qualified tuition program, assets of the program must be held in a trust created or organized in the United States for the exclusive benefit of designated beneficiaries that complies with the requirements under section 408(a)(2) and (5). Under these rules, the trustee must be a bank or other person who demonstrates that it will administer the trust in accordance with applicable requirements and the assets of the trust may not be commingled with other property except in a common trust fund or common investment fund.

The Act repeals the present-law rule that a qualified state tuition program must impose a more than *de minimis* monetary penalty on any refund of earnings not used for qualified higher education expenses of the beneficiary (except in certain circumstances). Instead, the Act imposes an additional 10% tax on the amount of a distribution from a qualified tuition plan that is includible in gross income (like the additional tax that applies to such distributions from education IRAs). The same exceptions that apply to the 10% additional tax with respect to education IRAs apply.

A special rule applies because the exclusion for earnings on distributions used for qualified higher education expenses does not apply to qualified tuition programs of private institutions until 2004. Under the special rule, the additional 10% tax does not apply to any payment in a taxable year beginning before January 1, 2004, which is includible in gross income but used for qualified higher education expenses. Thus, for example, the earnings portion of a distribution from a qualified tuition program of a private institution that is made in 2003 and that is used for qualified higher education expenses is not subject to the additional tax, even though the earnings portion is includible in gross income. Conforming the penalty to the education IRA provisions will make it easier for taxpayers to allocate expenses between the various education tax incentives. For example, under the Act, a taxpayer who receives distributions from an education IRA and a qualified tuition program in the same year is required to allocate qualified expenses in order to determine the amount excludable from income. Other interactions between the various provisions also arise under the Act. For example, a taxpayer may need to know the amount excludable from income due to a distribution from a qualified tuition program in order to determine the amount of expenses eligible for the tuition deduction. It is expected that the Secretary will exercise the existing authority under sections 529(d) and 530(h) to require appropriate reporting, e.g., the amount of distributions and the earnings portions of distributions (taxable and nontaxable), to facilitate the provisions of the Act.

#### *Exclusion from gross income*

Under the Act, an exclusion from gross income is provided for distributions made in taxable years beginning after December 31, 2001, from qualified state tuition programs to the extent that the distribution is used to pay for qualified higher education expenses. This exclusion from gross income is extended to distributions from qualified tuition programs established and maintained by an entity other than a state (or agency or instrumentality thereof) for distributions made in taxable years after December 31, 2003.

#### *Qualified higher education expenses*

The Act provides that, for purposes of the exclusion for distributions from qualified tuition plans, the maximum room and board allowance is the amount applicable to the student in calculating costs of attendance for federal financial aid programs under section 472 of the Higher Education Act of 1965, as in effect on June 7, 2001, or, in the case of a student living in housing owned or operated by an eligible educational institution, the actual amount charged the student by the educational institution for room and board. This definition also applies to distributions from education IRAs.

The Act modifies the definition of qualified higher education expenses to include expenses of a special needs beneficiary that are necessary in connection with his or her enrollment or attendance at the eligible education institution. This definition also applies to distributions from education IRAs. In addition, a special needs beneficiary would be defined as under the provisions relating to education IRAs, described above.

#### *Coordination with HOPE and Lifetime Learning credits*

The Act allows a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the principal and the earnings portions) from a qualified tuition program on behalf of the same student as long as the distribution is not used for the same expenses for which a credit was claimed.

### *Rollovers for benefit of same beneficiary*

The Act provides that a transfer of credits (or other amounts) from one qualified tuition program for the benefit of a designated beneficiary to another qualified tuition program for the benefit of the same beneficiary is not considered a distribution. This rollover treatment does not apply to more than one transfer within any 12-month period with respect to the same beneficiary. The intent of this provision is to allow, for example, transfers between a prepaid tuition program and a savings program maintained by the same state and between a state plan and a private prepaid tuition program.

### *Member of family*

The Act provides that, for purposes of tax-free rollovers and changes of designated beneficiaries, a “member of the family” includes first cousins of the original beneficiary.

### Effective Date

The provisions are effective for taxable years beginning after December 31, 2001, except that the exclusion from gross income for certain distributions from a qualified tuition program established and maintained by an entity other than a state (or agency or instrumentality thereof) is effective for taxable years beginning after December 31, 2003.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to qualified tuition programs. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
601-603	INDIVIDUAL RETIREMENT ARRANGEMENT

### Background

There are two general types of individual retirement arrangements (“IRAs”) under present law: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs. The federal income tax rules regarding each type of IRA (and IRA contribution) differ.

#### *Traditional IRAs*

Under present law, an individual may make deductible contributions to an IRA up to the lesser of \$2,000 or the individual's compensation if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. In the case of a married couple, deductible IRA contributions of up to \$2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount. If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the \$2,000 deduction limit is phased out for taxpayers with adjusted gross income (“AGI”) over certain levels for the taxable year.

The AGI phase-out limits for taxpayers who are active participants in employer-sponsored plans are as follows.

Single Taxpayers	
Taxable years beginning in:	Phase-out range
2001	\$33,000 43,000
2002	34,000 44,000
2003	40,000 50,000
2004	45,000 55,000
2005 and thereafter	50,000 60,000

  

Joint Returns	
Taxable years beginning in:	Phase-out range
2001	\$53,000 63,000
2002	54,000 64,000
2003	60,000 70,000
2004	65,000 75,000
2005	70,000 80,000
2006	75,000 85,000
2007 and thereafter	80,000 100,000

The AGI phase-out range for married taxpayers filing a separate return is \$0 to \$10,000.

If the individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the \$2,000 deduction limit is phased out for taxpayers with AGI between \$150,000 and \$160,000.

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to a traditional IRA.

Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Includible amounts withdrawn prior to attainment of age 59 1/2 are subject to an additional 10% early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5% of AGI, is used to purchase health insurance of an unemployed individual, is used for education expenses, or is used for first-time homebuyer expenses of up to \$10,000.

#### *Roth IRAs*

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of \$2,000 or the individual's compensation for the year. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to IRAs generally, a contribution of up to \$2,000 for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for single individuals with AGI between \$95,000 and \$110,000 and for joint filers with AGI between \$150,000 and \$160,000.

Taxpayers with modified AGI of \$100,000 or less generally may convert a traditional IRA into a Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10% early withdrawal tax does not apply and, if the conversion occurred in 1998, the income inclusion may be spread ratably over four years. Married taxpayers who file separate returns cannot convert a traditional IRA into a Roth IRA.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10% tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) which is made after attainment of age 59 1/2, on account of death or disability, or is made for first-time homebuyer expenses of up to \$10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10% early withdrawal tax (unless an exception applies). The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs. Early distribution of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the four-year rule applicable to 1998 conversions.

#### New Federal Law (Sec. 219, 408, & 408A)

##### *Increase in annual contribution limits*

The Act increases the maximum annual dollar contribution limit for IRA contributions from \$2,000 to \$3,000 for 2002 through 2004, \$4,000 for 2005 through 2007, and \$5,000 for 2008. After 2008, the limit is adjusted annually for inflation in \$500 increments.

##### *Additional catch-up contributions*

The Act provides that individuals who have attained age 50 may make additional catch-up IRA contributions. The otherwise maximum contribution limit (before application of the AGI phase-out limits) for an individual who has attained age 50 before the end of the taxable year is increased by \$500 for 2002 through 2005, and \$1,000 for 2006 and thereafter.

##### *Deemed IRAs under employer plans*

The Act provides that, if an eligible retirement plan permits employees to make voluntary employee contributions to a separate account or annuity that (1) is established under the plan, and (2) meets the requirements applicable to either traditional IRAs or Roth IRAs, then the separate account or annuity is deemed a traditional IRA or a Roth IRA, as applicable, for all purposes of the Code. For example, the reporting requirements applicable to IRAs apply. The deemed IRA, and contributions thereto, are not subject to the Code rules pertaining to the eligible retirement plan. In addition, the deemed IRA, and contributions thereto, are not taken into account in applying such rules to any other contributions under the plan. The deemed IRA, and contributions thereto, are subject to the exclusive benefit and fiduciary rules of ERISA to the extent otherwise applicable to the plan, and are not subject to the ERISA reporting and disclosure, participation, vesting, funding, and enforcement requirements applicable to the eligible retirement plan. An eligible retirement plan is a qualified plan (sec. 401(a)), tax-sheltered annuity (sec. 403(b)), or a governmental section 457 plan.

The Act does not specify the treatment of deemed IRAs for purposes other than the Code and ERISA.



### Effective Date

The provisions are generally effective for taxable years beginning after December 31, 2001. The provision relating to deemed IRAs under employer plans is effective for plan years beginning after December 31, 2002.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to IRAs. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
611	PENSION PROVISIONS - INCREASE IN BENEFIT AND CONTRIBUTION LIMITS.

### Background

#### *In general*

Present law imposes limits on contributions and benefits under qualified plans (sec. 415), the amount of compensation that may be taken into account under a plan for determining benefits (sec. 401(a)(17)), the amount of elective deferrals that an individual may make to a salary reduction plan or tax sheltered annuity (sec. 402(g)), and deferrals under an eligible deferred compensation plan of a tax-exempt organization or a state or local government (sec. 457).

#### *Limitations on contributions and benefits*

Under present law, the limits on contributions and benefits under qualified plans are based on the type of plan. Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of (1) 25% of compensation or (2) \$35,000 (for 2001). Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. The \$35,000 limit is indexed for cost-of-living adjustments in \$5,000 increments. Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) 100% of average compensation, or (2) \$140,000 (for 2001). The dollar limit is adjusted for cost-of-living increases in \$5,000 increments. Under present law, in general, the dollar limit on annual benefits is reduced if benefits under the plan begin before the social security retirement age (currently, age 65) and increased if benefits begin after social security retirement age.

#### *Compensation limitation*

Under present law, the annual compensation of each participant that may be taken into account for purposes of determining contributions and benefits under a plan, applying the deduction rules, and for nondiscrimination testing purposes is limited to \$170,000 (for 2001). The compensation limit is indexed for cost-of-living adjustments in \$10,000 increments.

In general, contributions to qualified plans and IRAs are based on compensation. For a self-employed individual, compensation generally means net earnings subject to self-employment taxes ("SECA taxes").

Members of certain religious faiths may elect to be exempt from SECA taxes on religious grounds. Because the net earnings of such individuals are not subject to SECA taxes, these individuals are considered to have no compensation on which to base contributions to a retirement plan. Under an exception to this rule, net earnings of such individuals are treated as compensation for purposes of making contributions to an IRA.

#### *Elective deferral limitations*

Under present law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals.

The maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a "section 401(k) plan"), a tax-sheltered annuity ("section 403(b) annuity") or a salary reduction simplified employee pension plan ("SEP") is \$10,500 (for 2001). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is \$6,500 (for 2001). These limits are indexed for inflation in \$500 increments.

#### *Section 457 plans*

The maximum annual deferral under a deferred compensation plan of a state or local government or a tax-exempt organization (a "section 457 plan") is the lesser of (1) \$8,500 (for 2001) or (2) 33 1/3% of compensation. The \$8,500 dollar limit is increased for inflation in \$500 increments. Under a special catch-up rule, the section 457 plan may provide that, for one or more of the participant's last three years before retirement, the otherwise applicable limit is increased to the lesser of (1) \$15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

#### New Federal Law (Sec. 401(a)(17), 401(c)(2), 402(g), 408(p), 415 & 457)

#### *Limits on contributions and benefits*

The Act increases the \$35,000 limit on annual additions to a defined contribution plan to \$40,000. This amount is indexed in \$1,000 increments. The Act increases the \$140,000 annual benefit limit under a defined benefit plan to \$160,000. The dollar limit is reduced for benefit commencement before age 62 and increased for benefit commencement after age 65. In adopting rules regarding the application of the increase in the defined benefit plan limits under the Act, it is intended that the Secretary will apply rules similar to those adopted in Notice 99-44 regarding benefit increases due to the repeal of the combined plan limit under former section 415(e). Thus, for example, a defined benefit plan could provide for benefit increases to reflect the provisions of the Act for a current or former employee who has commenced benefits under the plan prior to the effective date of the bill if the employee or former employee has an accrued benefit under the plan (other than an accrued benefit resulting from a benefit increase solely as a result of the increases in the section 415 limits under the bill). As under the notice, the maximum amount of permitted increase is generally the amount that could have been provided had the provisions of the Act been in effect at the time of the commencement of benefit. In no case may benefits reflect increases that could not be paid prior to the effective date because of the limits in effect under present law. In addition, in no case may plan amendments providing increased benefits under the relevant provision of the Act be effective prior to the effective date of the Act. Another provision of the Act modifies the defined benefit pension plan limits for multiemployer plans.

### *Compensation limitation*

The Act increases the limit on compensation that may be taken into account under a plan to \$200,000. This amount is indexed in \$5,000 increments. The Act also amends the definition of compensation for purposes of all qualified plans and IRAs (including SIMPLE arrangements) to include an individual's net earnings that would be subject to SECA taxes but for the fact that the individual is covered by a religious exemption.

### *Elective deferral limitations*

The Act increases the dollar limit on annual elective deferrals under section 401(k) plans, section 403(b) annuities and salary reduction SEPs to \$11,000 in 2002. In 2003 and thereafter, the limits are increased in \$1,000 annual increments until the limits reach \$15,000 in 2006, with indexing in \$500 increments thereafter. The Act increases the maximum annual elective deferrals that may be made to a SIMPLE plan to \$7,000 in 2002. In 2003 and thereafter, the SIMPLE plan deferral limit is increased in \$1,000 annual increments until the limit reaches \$10,000 in 2005. Beginning after 2005, the \$10,000 dollar limit is indexed in \$500 increments.

### *Section 457 plans*

The Act increases the dollar limit on deferrals under a section 457 plan to conform to the elective deferral limitation. Thus, the limit is \$11,000 in 2002, and is increased in \$1,000 annual increments thereafter until the limit reaches \$15,000 in 2006. The limit is indexed thereafter in \$500 increments. The limit is twice the otherwise applicable dollar limit in the three years prior to retirement.

### Effective Date

The provisions are generally effective for years beginning after December 31, 2001. The provisions relating to defined benefit plans are effective for years ending after December 31, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to contribution limits of pensions. California law has not conformed to the changes made to the IRC by the EGTRRA.

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### Section

### Section Title

612	PENSION PLAN - PLAN LOANS FOR S CORPORATION SHAREHOLDERS, PARTNERS, AND SOLE PROPRIETORS.
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### Background

The IRC prohibits certain transactions ("prohibited transactions") between a qualified plan and a disqualified person in order to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries. Certain types of transactions are exempted from the prohibited transaction rules, including loans from the plan-to-plan participants, if certain requirements are satisfied.

In addition, the Secretary of Labor can grant an administrative exemption from the prohibited transaction rules if the Secretary finds the exemption is administratively feasible, in the interest of the plan and plan participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan. Pursuant to this exemption process, the Secretary of Labor grants exemptions both with respect to specific transactions and classes of transactions.

The statutory exemptions to the prohibited transaction rules do not apply to certain transactions in which the plan makes a loan to an owner-employee. Certain transactions involving a plan and S corporation shareholders are permitted. Loans to participants other than owner-employees are permitted if loans are available to all participants on a reasonably equivalent basis, are not made available to highly compensated employees in an amount greater than made available to other employees, are made in accordance with specific provisions in the plan, bear a reasonable rate of interest, and are adequately secured. In addition, the Code places limits on the amount of loans and repayment terms.

For purposes of the prohibited transaction rules, an owner-employee means (1) a sole proprietor, (2) a partner who owns more than 10% of either the capital interest or the profits interest in the partnership, (3) an employee or officer of a Subchapter S corporation who owns more than 5% of the outstanding stock of the corporation, and (4) the owner of an individual retirement arrangement ("IRA"). The term owner-employee also includes certain family members of an owner-employee and certain corporations owned by an owner-employee.

Under the Internal Revenue Code, a two-tier excise tax is imposed on disqualified persons who engage in a prohibited transaction. The first level tax is equal to 15% of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period, and is equal to 100% of the amount involved.

#### New Federal Law (Sec. 4975)

The Act generally eliminates the special present-law rules relating to plan loans made to an owner-employee (other than the owner of an IRA). Thus, the general statutory exemption applies to such transactions. Present law continues to apply with respect to IRAs.

Congress intends that the Secretary of the Treasury and the Secretary of Labor will waive any penalty or excise tax in situations where a loan made prior to the effective date of the provision was exempt when initially made (treating any refinancing as a new loan) and the loan would have been exempt throughout the period of the loan if the provision had been in effect during the period of the loan.

#### Effective Date

The provision is effective with respect to years beginning after December 31, 2001

#### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to loans from pension plans, except that California law does not impose any excise tax on prohibited transactions. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
613	PENSION PLAN - MODIFICATION OF TOP-HEAVY RULES.

Background

*In general*

Under present law, additional qualification requirements apply to plans that primarily benefit an employer's key employees ("top-heavy plans"). These additional requirements provide (1) more rapid vesting for plan participants who are non-key employees and (2) minimum nonintegrated employer contributions or benefits for plan participants who are non-key employees.

*Definition of top-heavy plan*

A defined benefit plan is a top-heavy plan if more than 60% of the cumulative accrued benefits under the plan are for key employees. A defined contribution plan is top heavy if the sum of the account balances of key employees is more than 60% of the total account balances under the plan. For each plan year, the determination of top-heavy status generally is made as of the last day of the preceding plan year ("the determination date").

For purposes of determining whether a plan is a top-heavy plan, benefits derived both from employer and employee contributions, including employee elective contributions, are taken into account. In addition, the accrued benefit of a participant in a defined benefit plan and the account balance of a participant in a defined contribution plan includes any amount distributed within the five-year period ending on the determination date.

An individual's accrued benefit or account balance is not taken into account in determining whether a plan is top-heavy if the individual has not performed services for the employer during the five-year period ending on the determination date.

In some cases, two or more plans of a single employer must be aggregated for purposes of determining whether the group of plans is top-heavy. The following plans must be aggregated: (1) plans which cover a key employee (including collectively bargained plans); and (2) any plan upon which a plan covering a key employee depends for purposes of satisfying the Code's nondiscrimination rules. The employer may be required to include terminated plans in the required aggregation group. In some circumstances, an employer may elect to aggregate plans for purposes of determining whether they are top heavy.

SIMPLE plans are not subject to the top-heavy rules.

*Definition of key employee*

A key employee is an employee who, during the plan year that ends on the determination date or any of the four preceding plan years, is (1) an officer earning over one-half of the defined benefit plan dollar limitation of section 415 (\$70,000 for 2001), (2) a 5% owner of the employer, (3) a 1% owner of the employer earning over \$150,000, or (4) one of the 10 employees earning more than the defined contribution plan dollar limit (\$35,000 for 2001) with the largest ownership interests in the employer. A family ownership attribution rule applies to the determination of 1% owner status, 5% owner status, and largest ownership interest. Under this attribution rule, an individual is treated as owning stock owned by the individual's spouse, children, grandchildren, or parents.

### *Minimum benefit for non-key employees*

A minimum benefit generally must be provided to all non-key employees in a top-heavy plan. In general, a top-heavy defined benefit plan must provide a minimum benefit equal to the lesser of (1) 2% of compensation multiplied by the employee's years of service, or (2) 20% of compensation. A top-heavy defined contribution plan must provide a minimum annual contribution equal to the lesser of (1) 3% of compensation, or (2) the percentage of compensation at which contributions were made for key employees (including employee elective contributions made by key employees and employer matching contributions).

For purposes of the minimum benefit rules, only benefits derived from employer contributions (other than amounts employees have elected to defer) to the plan are taken into account, and an employee's social security benefits are disregarded (i.e., the minimum benefit is nonintegrated). Employer matching contributions may be used to satisfy the minimum contribution requirement; however, in such a case the contributions are not treated as matching contributions for purposes of applying the special nondiscrimination requirements applicable to employee elective contributions and matching contributions under sections 401(k) and (m). Thus, such contributions would have to meet the general nondiscrimination test of section 401(a)(4).

### *Top-heavy vesting*

Benefits under a top-heavy plan must vest at least as rapidly as under one of the following schedules:

- (1) three-year cliff vesting, which provides for 100% vesting after three years of service; and
- (2) two-six year graduated vesting, which provides for 20% vesting after two years of service, and 20% more each year thereafter so that a participant is fully vested after six years of service.

Benefits under a plan that is not top heavy must vest at least as rapidly as under one of the following schedules:

- (1) five-year cliff vesting; and
- (2) three-seven year graded vesting, which provides for 20% vesting after three years and 20% more each year thereafter so that a participant is fully vested after seven years of service.

### *Qualified cash or deferred arrangements*

Under a qualified cash or deferred arrangement (a "section 401(k) plan"), an employee may elect to have the employer make payments as contributions to a qualified plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. A special nondiscrimination test applies to elective deferrals under cash or deferred arrangements, which compares the elective deferrals of highly compensated employees with elective deferrals of nonhighly compensated employees. (This test is called the actual deferral percentage test or the "ADP" test). Employer matching contributions under qualified defined contribution plans are also subject to a similar nondiscrimination test. (This test is called the actual contribution percentage test or the "ACP" test.)

Under a design-based safe harbor, a cash or deferred arrangement is deemed to satisfy the ADP test if the plan satisfies one of two contribution requirements and satisfies a notice requirement. A plan satisfies the contribution requirement under the safe harbor rule for qualified cash or deferred arrangements if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to the permitted disparity rules (sec. 401(1)).

A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100% of the employee's elective deferrals up to 3% of compensation and (b) 50% of the employee's elective deferrals from 3% to 5% of compensation; and (2), the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Matching contributions that satisfy the design-based safe harbor for cash or deferred arrangements are deemed to satisfy the ACP test. Certain additional matching contributions are also deemed to satisfy the ACP test.

### New Federal Law (Sec. 416)

#### *Definition of top-heavy plan*

The Act provides that a plan consisting of a cash-or-deferred arrangement that satisfies the design-based safe harbor for such plans and matching contributions that satisfy the safe harbor rule for such contributions is not a top-heavy plan. Matching or nonelective contributions provided under such a plan may be taken into account in satisfying the minimum contribution requirements applicable to top-heavy plans. This provision is not intended to preclude the use of nonelective contributions that are used to satisfy the safe harbor rules from being used to satisfy other qualified retirement plan nondiscrimination rules, including those involving cross-testing.

In determining whether a plan is top-heavy, distributions during the year ending on the date the top-heavy determination is being made are taken into account. The present-law five-year rule applies with respect to in-service distributions. Similarly, the Act provides that an individual's accrued benefit or account balance is not taken into account if the individual has not performed services for the employer during the one-year period ending on the date the top-heavy determination is being made.

#### *Definition of key employee*

The Act: (1) provides that an employee is not considered a key employee by reason of officer status unless the employee was (a) an officer with compensation in excess of \$130,000 (adjusted for inflation in \$5,000 increments), (b) a 5% owner, or (c) a 1% owner with compensation in excess of \$150,000, and (2) repeals the top-10 owner key employee category. The present-law limits on the number of officers treated as key employees under (1) continue to apply. The Act repeals the four-year lookback rule for determining key employee status and provides that an employee is a key employee only if he or she is a key employee during the preceding plan year.

An employee is considered a key employee if, during the prior year, the employee was (1) an officer with compensation in excess of \$130,000 (adjusted for inflation in \$5,000 increments), (2) a 5% owner, or (3) a 1% owner with compensation in excess of \$150,000. The present-law limits on the number of officers treated as key employees under (1) continue to apply.

Under the Act, the family ownership attribution rule continues to apply in determining whether an individual is a 5% owner of the employer for purposes of the top-heavy rules.

#### *Minimum benefit for non-key employees*

Under the Act, matching contributions are taken into account in determining whether the minimum benefit requirement has been satisfied. Thus, this provision overrides the provision in Treasury regulations that, if matching contributions are used to satisfy the minimum benefit requirement, then they are not treated as matching contributions for purposes of the section 401(m) nondiscrimination rules.

The Act provides that, in determining the minimum benefit required under a defined benefit plan, a year of service does not include any year in which no key employee or former key employee benefits under the plan (as determined under sec. 410).

#### Effective Date

The provision is effective for years beginning after December 31, 2001.

#### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to top heavy rules for pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
614	ELECTIVE DEFERRALS NOT TAKEN INTO ACCOUNT FOR PURPOSES OF DEDUCTION LIMITS.

#### Background

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan's unfunded current liabilities.

In the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15% of compensation of the employees covered by the plan for the year.

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of (1) 25% of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

For purposes of the deduction limits, employee elective deferral contributions to a section 401(k) plan are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.

Subject to certain exceptions, nondeductible contributions are subject to a 10% excise tax.



### New Federal Law (Sec. 404)

Under the Act, elective deferral contributions are not subject to the deduction limits, and the application of a deduction limitation to any other employer contribution to a qualified retirement plan does not take into account elective deferral contributions.

### Effective Date

The provision is effective for years beginning after December 31, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to deferrals for pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
615	REPEAL OF COORDINATION REQUIREMENTS FOR DEFERRED COMPENSATION PLANS OF STATE AND LOCAL GOVERNMENTS AND TAX-EXEMPT ORGANIZATIONS.

### Background

Compensation deferred under an eligible deferred compensation plan of a tax-exempt or state and local government employer (a "section 457 plan") is not includible in gross income until paid or made available. In general, the maximum permitted annual deferral under such a plan is the lesser of (1) \$8,500 (in 2001) or (2) 33 1/3% of compensation. The \$8,500 limit is increased for inflation in \$500 increments. Under a special catch-up rule, a section 457 plan may provide that, for one or more of the participant's last three years before retirement, the otherwise applicable limit is increased to the lesser of (1) \$15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

The \$8,500 limit (as modified under the catch-up rule), applies to all deferrals under all section 457 plans in which the individual participates. In addition, in applying the \$8,500 limit, contributions under a tax-sheltered annuity ("section 403(b) annuity"), elective deferrals under a qualified cash or deferred arrangement ("section 401(k) plan"), salary reduction contributions under a simplified employee pension plan ("SEP"), and contributions under a SIMPLE plan are taken into account. Further, the amount deferred under a section 457 plan is taken into account in applying a special catch-up rule for section 403(b) annuities.

### New Federal Law (Sec. 457)

The Act repeals the rules coordinating the section 457 dollar limit with contributions under other types of plans. (The limits on deferrals under a section 457 plan are modified under other provisions of the Act.)

### Effective Date

The provision is effective for years beginning after December 31, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

<u>Section</u>	<u>Section Title</u>
616	PENSION PLAN - DEDUCTION LIMITS.

### Background

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan. Subject to certain exceptions, nondeductible contributions are subject to a 10% excise tax.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan's unfunded current liabilities.

In some cases, the amount of deductible contributions is limited by compensation. In the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15% of compensation of the employees covered by the plan for the year.

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of (1) 25% of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

In the case of an employee stock ownership plan ("ESOP"), principal payments on a loan used to acquire qualifying employer securities are deductible up to 25% of compensation.

For purposes of the deduction limits, employee elective deferral contributions to a qualified cash or deferred arrangement ("section 401(k) plan") are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.

For purposes of the deduction limits, compensation means the compensation otherwise paid or accrued during the taxable year to the beneficiaries under the plan, and the beneficiaries under a profit-sharing or stock bonus plan are the employees who benefit under the plan with respect to the employer's contribution. An employee who is eligible to make elective deferrals under a section 401(k) plan is treated as benefiting under the arrangement even if the employee elects not to defer.

For purposes of the deduction rules, compensation generally includes only taxable compensation, and thus does not include salary reduction amounts, such as elective deferrals under a section 401(k) plan or a tax-sheltered annuity ("section 403(b) annuity"), elective contributions under a deferred compensation plan of a tax-exempt organization or a state or local government ("section 457 plan"), and salary reduction contributions under a section 125 cafeteria plan. For purposes of the contribution limits under section 415, compensation does include such salary reduction amounts.

### New Federal Law (Sec. 404)

Under the Act, the definition of compensation for purposes of the deduction rules includes salary reduction amounts treated as compensation under section 415. In addition, the annual limitation on the amount of deductible contributions to a profit-sharing or stock bonus plan is increased from 15% to 25% of compensation of the employees covered by the plan for the year. Also, except to the extent provided in regulations, a money purchase pension plan is treated like a profit-sharing or stock bonus plan for purposes of the deduction rules.

### Effective Date

The provision is effective for years beginning after December 31, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to deduction limits for pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
617	OPTION TO TREAT ELECTIVE DEFERRALS AS AFTER-TAX CONTRIBUTIONS

### Background

A qualified cash or deferred arrangement ("section 401(k) plan") or a tax-sheltered annuity ("section 403(b) annuity") may permit a participant to elect to have the employer make payments as contributions to the plan or to the participant directly in cash. Contributions made to the plan at the election of a participant are elective deferrals. Elective deferrals must be nonforfeitable and are subject to an annual dollar limitation (sec. 402(g)) and distribution restrictions. In addition, elective deferrals under a section 401(k) plan are subject to special nondiscrimination rules. Elective deferrals (and earnings attributable thereto) are not includible in a participant's gross income until distributed from the plan.

Elective deferrals for a taxable year that exceed the annual dollar limitation ("excess deferrals") are includible in gross income for the taxable year. If an employee makes elective deferrals under a plan (or plans) of a single employer that exceed the annual dollar limitation ("excess deferrals"), then the plan may provide for the distribution of the excess deferrals, with earnings thereon. If the excess deferrals are made to more than one plan of unrelated employers, then the plan may permit the individual to allocate excess deferrals among the various plans, no later than March 1 (April 15 under the applicable regulations) following the end of the taxable year. If excess deferrals are distributed not later than April 15 following the end of the taxable year, along with earnings attributable to the excess deferrals, then the excess deferrals are not again includible in income when distributed. The earnings are includible in income in the year distributed. If excess deferrals (and income thereon) are not distributed by the applicable April 15, then the excess deferrals (and income thereon) are includible in income when received by the participant. Thus, excess deferrals that are not distributed by the applicable April 15th are taxable both in the taxable year when the deferral was made and in the year the participant receives a distribution of the excess deferral.

Individuals with adjusted gross income below certain levels generally may make nondeductible contributions to a Roth IRA and may convert a deductible or nondeductible IRA into a Roth IRA. Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, nor subject to the additional 10% tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59 1/2, is made on account of death or disability, or is a qualified special purpose distribution (i.e., for first-time homebuyer expenses of up to \$10,000). A distribution from a Roth IRA that is not a qualified distribution is includible in income to the extent attributable to earnings, and is subject to the 10% tax on early withdrawals (unless an exception applies). Early distributions of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the four-year rule applicable to 1998 conversions.

### New Federal Law (Sec. 402A)

A section 401(k) plan or a section 403(b) annuity is permitted to include a "designated Roth contribution" that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as designated Roth contributions. Designated Roth contributions are elective deferrals that the participant designates (at such time and in such manner as the Secretary may prescribe) as not excludable from the participant's gross income. It is intended that the Secretary will generally not permit retroactive designations of elective deferrals as designated Roth contributions.

The annual dollar limitation on a participant's designated Roth contributions is the section 402(g) annual limitation on elective deferrals, reduced by the participant's elective deferrals that the participant does not designate as designated Roth contributions. Designated Roth contributions are treated as any other elective deferral for purposes of nonforfeitability requirements and distribution restrictions. Similarly, designated Roth contributions to a section 403(b) annuity are treated the same as other salary reduction contributions to the annuity (except that designated Roth contributions are includible in income).

Under a section 401(k) plan, designated Roth contributions also are treated as any other elective deferral for purposes of the special nondiscrimination requirements. It is intended that the Secretary provide ordering rules regarding the return of excess contributions under the special nondiscrimination rules (pursuant to sec. 401(k)(8)) in the event a participant makes both regular elective deferrals and designated Roth contributions. It is intended that such rules will generally permit a plan to allow participants to designate which contributions are returned first or to permit the plan to specify which contributions are returned first. It is also intended that the Secretary will provide ordering rules to determine the extent to which a distribution consists of excess Roth contributions.

The plan is required to establish a separate account, and maintain separate record keeping, for a participant's designated Roth contributions (and earnings allocable thereto). A qualified distribution from a participant's designated Roth contributions account is not includible in the participant's gross income. A qualified distribution is a distribution that is made after the end of a specified nonexclusion period and that is (1) made on or after the date on which the participant attains age 59 1/2, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled. A qualified special purpose distribution, as defined under the rules relating to Roth IRAs, does not qualify as a tax-free distribution from a designated Roth contributions account.

The nonexclusion period is the five-year-taxable period beginning with the earlier of (1) the first taxable year for which the participant made a designated Roth contribution to any designated Roth contribution account established for the participant under the plan, or (2) if the participant has made a rollover contribution to the designated Roth contribution account that is the source of the distribution from a designated Roth contribution account established for the participant under another plan, the first taxable year for which the participant made a designated Roth contribution to the previously established account.

A distribution from a designated Roth contributions account that is a corrective distribution of an elective deferral (and income allocable thereto) that exceeds the section 402(g) annual limit on elective deferrals or a corrective distribution of an excess contribution under the special nondiscrimination rules (pursuant to sec. 401(k)(8) (and income allocable thereto) is not a qualified distribution. In addition, the treatment of excess designated Roth contributions is similar to the treatment of excess deferrals attributable to non-designated Roth contributions. If excess designated Roth contributions (including earnings thereon) are distributed no later than the April 15th following the taxable year, then the designated Roth contribution is not includible in gross income as a result of the distribution, because such contributions are includible in gross income when made. Earnings on such excess designated Roth contributions are treated the same as earnings on excess deferrals distributed no later than April 15th, i.e., they are includible in income when distributed. If excess designated Roth contributions are not distributed no later than the applicable April 15th, then such contributions (and earnings thereon) are taxable when distributed. Thus, as is the case with excess elective deferrals that are not distributed by the applicable April 15th, the contributions are includible in income in the year when made and again when distributed from the plan. Earnings on such contributions are taxable when received.

A participant is permitted to roll over a distribution from a designated Roth contributions account only to another designated plus contributions account or a Roth IRA of the participant.

The Secretary of the Treasury is directed to require the plan administrator of each section 401(k) plan or section 403(b) annuity that permits participants to make designated Roth contributions to make such returns and reports regarding designated Roth contributions to the Secretary, plan participants and beneficiaries, and other persons that the Secretary may designate.

#### Effective Date

The provision is effective for taxable years beginning after December 31, 2005.

#### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

<u>Section</u>	<u>Section Title</u>
618	PENSION PLAN - NONREFUNDABLE CREDIT TO CERTAIN INDIVIDUALS FOR ELECTIVE DEFERRALS AND IRA CONTRIBUTIONS

### Background

Present law provides favorable tax treatment for a variety of retirement savings vehicles, including employer-sponsored retirement plans and individual retirement arrangements ("IRAs").

Several different types of tax-favored employer-sponsored retirement plans exist, such as section 401(a) qualified plans (including plans with a section 401(k) qualified cash-or-deferred arrangement), section 403(a) qualified annuity plans, section 403(b) annuities, section 408(k) simplified employee pensions ("SEPs"), section 408(p) SIMPLE retirement accounts, and section 457(b) eligible deferred compensation plans. In general, an employer and, in certain cases, employees, contribute to the plan. Taxation of the contributions and earnings thereon is generally deferred until benefits are distributed from the plan to participants or their beneficiaries. In the case of after-tax employee contributions, only earnings are taxed upon withdrawal. Contributions and benefits under tax-favored employer-sponsored retirement plans are subject to specific limitations.

Coverage and nondiscrimination rules also generally apply to tax-favored employer-sponsored retirement plans to ensure that plans do not disproportionately cover higher-paid employees and that benefits provided to moderate- and lower-paid employees are generally proportional to those provided to higher-paid employees.

IRAs include both traditional IRAs and Roth IRAs. In general, an individual makes contributions to an IRA, and investment earnings on those contributions accumulate on a tax-deferred basis. Total annual IRA contributions per individual are limited to \$2,000 (or the compensation of the individual or the individual's spouse, if smaller). Contributions to a traditional IRA may be deducted from gross income if an individual's adjusted gross income ("AGI") is below certain levels or the individual is not an active participant in certain employer-sponsored retirement plans. Contributions to a Roth IRA are not deductible from gross income, regardless of adjusted gross income. A distribution from a traditional IRA is includible in the individual's gross income except to the extent of individual contributions made on a nondeductible basis. A qualified distribution from a Roth IRA is excludable from gross income.

Taxable distributions made from employer retirement plans and IRAs before the employee or individual has reached age 59 1/2 are subject to a 10% additional tax, unless an exception applies.

### New Federal Law (Sec. 25B)

The Act provides a temporary nonrefundable tax credit for contributions made by eligible taxpayers to a qualified plan. The maximum annual contribution eligible for the credit is \$2,000. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. Only joint returns with AGI of \$50,000 or less, head of household returns of \$37,500 or less, and single returns of \$25,000 or less are eligible for the credit. The AGI limits applicable to single taxpayers apply to married taxpayers filing separate returns. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

The credit is available with respect to elective contributions to a section 401(k) plan, section 403(b) annuity, or eligible deferred compensation arrangement of a state or local government (a "sec. 457 plan"), SIMPLE, or SEP, contributions to a traditional or Roth IRA, and voluntary after-tax employee contributions to a qualified retirement plan. The present-law rules governing such contributions continue to apply.

The amount of any contribution eligible for the credit is reduced by taxable distributions received by the taxpayer and his or her spouse from any savings arrangement described above or any other qualified retirement plan during the taxable year for which the credit is claimed, the two taxable years prior to the year the credit is claimed, and during the period after the end of the taxable year and prior to the due date for filing the taxpayer's return for the year. In the case of a distribution from a Roth IRA, this rule applies to any such distributions, whether or not taxable.

The credit rates based on AGI are as follows.

Joint filers	Heads of households	All other filers	Credit rate
\$0-\$30,000	\$0-\$22,500	\$0-\$15,000	50%
\$30,000-\$32,500	\$22,500-\$24,375	\$15,000-\$16,250	20%
\$32,500-\$50,000	\$24,375-\$37,500	\$16,250-\$25,000	10%
Over \$50,000	Over \$37,500	Over \$25,000	0%

The Act directs the Secretary of the Treasury to report annually to the Senate Finance Committee and the House Committee on Ways and Means regarding the number of individuals who claim the credit.

#### Effective Date

The provision is effective for taxable years beginning after December 31, 2001, and before January 1, 2007.

#### California Law

California has no comparable credit.

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<u>Section</u>	<u>Section Title</u>
619	PENSION PLAN - SMALL BUSINESS TAX CREDIT FOR NEW RETIREMENT PLAN EXPENSES

#### Background

The costs incurred by an employer related to the establishment and maintenance of a retirement plan (e.g., payroll system changes, investment vehicle set-up fees, consulting fees) generally are deductible by the employer as ordinary and necessary expenses in carrying on a trade or business.

#### New Federal Law (Sec. 45E)

The Act provides a nonrefundable income tax credit for 50% of the administrative and retirement-education expenses for any small business that adopts a new qualified defined benefit or defined contribution plan (including a section 401(k) plan), SIMPLE plan, or simplified employee pension ("SEP").

The credit applies to 50% of the first \$1,000 in administrative and retirement-education expenses for the plan for each of the first three years of the plan.

The credit is available to an employer that did not employ, in the preceding year, more than 100 employees with compensation in excess of \$5,000. In order for an employer to be eligible for the credit, the plan must cover at least one nonhighly compensated employee. In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement must be made available to all employees of the employer who have worked with the employer for at least three months.

The credit is a general business credit. The 50% of qualifying expenses that are effectively offset by the tax credit are not deductible; the other 50% of the qualifying expenses (and other expenses) are deductible to the extent permitted under present law.

#### Effective Date

The Act is effective with respect to costs paid or incurred in taxable years beginning after December 31, 2001, with respect to plans established after such date.

#### California Law

California has no comparable credit.

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<u>Section</u>	<u>Section Title</u>
631	ENHANCING FAIRNESS FOR WOMEN - ADDITIONAL SALARY REDUCTION CATCH-UP CONTRIBUTIONS.

#### Background

##### *Elective deferral limitations*

Under present law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a "401(k) plan"), a tax-sheltered annuity ("section 403(b) annuity") or a salary reduction simplified employee pension plan ("SEP") is \$10,500 (for 2001). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is \$6,500 (for 2001). These limits are indexed for inflation in \$500 increments.

##### *Section 457 plans*

The maximum annual deferral under a deferred compensation plan of a state or local government or a tax-exempt organization (a "section 457 plan") is the lesser of (1) \$8,500 (for 2001) or (2) 33 1/3% of compensation. The \$8,500 dollar limit is increased for inflation in \$500 increments. Under a special catch-up rule, the section 457 plan may provide that, for one or more of the participant's last three years before retirement, the otherwise applicable limit is increased to the lesser of (1) \$15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.



### New Federal Law (Sec. 414)

The Act provides that the otherwise applicable dollar limit on elective deferrals under a section 401(k) plan, section 403(b) annuity, SEP, or SIMPLE, or deferrals under a section 457 plan is increased for individuals who have attained age 50 by the end of the year. Another provision of the Act increases the dollar limit on elective deferrals under such arrangements. The catch-up contribution provision does not apply to after-tax employee contributions. Additional contributions may be made by an individual who has attained age 50 before the end of the plan year and with respect to whom no other elective deferrals may otherwise be made to the plan for the year because of the application of any limitation of the Code (e.g., the annual limit on elective deferrals) or of the plan. Under the Act, the additional amount of elective contributions that may be made by an eligible individual participating in such a plan is the lesser of (1) the applicable dollar amount or (2) the participant's compensation for the year reduced by any other elective deferrals of the participant for the year. In the case of a section 457 plan, this catch-up rule does not apply during the participant's last three years before retirement (in those years, the regularly applicable dollar limit is doubled). The applicable dollar amount under a section 401(k) plan, section 403(b) annuity, SEP, or section 457 plan is \$1,000 for 2002, \$2,000 for 2003, \$3,000 for 2004, \$4,000 for 2005, and \$5,000 for 2006 and thereafter. The applicable dollar amount under a SIMPLE is \$500 for 2002, \$1,000 for 2003, \$1,500 for 2004, \$2,000 for 2005, and \$2,500 for 2006 and thereafter. The \$5,000 and \$2,500 amounts are adjusted for inflation in \$500 increments in 2007 and thereafter. In the case of a section 457 plan, this catch-up rule does not apply during the participant's last three years before retirement (in those years, the regularly applicable dollar limit is doubled).

Catch-up contributions made under the Act are not subject to any other contribution limits and are not taken into account in applying other contribution limits. In addition, such contributions are not subject to applicable nondiscrimination rules. However, a plan fails to meet the applicable nondiscrimination requirements under section 401(a)(4) with respect to benefits, rights, and features unless the plan allows all eligible individuals participating in the plan to make the same election with respect to catch-up contributions. For purposes of this rule, all plans of related employers are treated as a single plan.

An employer is permitted to make matching contributions with respect to catch-up contributions. Any such matching contributions are subject to the normally applicable rules.

The following examples illustrate the application of the Act, after the catch-up is fully phased-in.

Example 1: Employee A is a highly compensated employee who is over 50 and who participates in a section 401(k) plan sponsored by A's employer. The maximum annual deferral limit (without regard to the provision) is \$15,000. After application of the special nondiscrimination rules applicable to section 401(k) plans, the maximum elective deferral A may make for the year is \$8,000. Under the provision, A is able to make additional catch-up salary reduction contributions of \$5,000.

Example 2: Employee B, who is over 50, is a participant in a section 401(k) plan. B's compensation for the year is \$30,000. The maximum annual deferral limit (without regard to the provision) is \$15,000. Under the terms of the plan, the maximum permitted deferral is 10% of compensation or, in B's case, \$3,000. Under the provision, B can contribute up to \$8,000 for the year (\$3,000 under the normal operation of the plan, and an additional \$5,000 under the provision).

### Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

## California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
632	ENHANCING FAIRNESS FOR WOMAN - EQUITABLE TREATMENT FOR CONTRIBUTIONS OF EMPLOYEES TO DEFINED CONTRIBUTION PLANS

## Background

Present law imposes limits on the contributions that may be made to tax-favored retirement plans.

### *Defined contribution plans*

In the case of a tax-qualified defined contribution plan, the limit on annual additions that can be made to the plan on behalf of an employee is the lesser of \$35,000 (for 2001) or 25% of the employee's compensation (sec. 415(c)). Annual additions include employer contributions, including contributions made at the election of the employee (i.e., employee elective deferrals), after-tax employee contributions, and any forfeitures allocated to the employee. For this purpose, compensation means taxable compensation of the employee, plus elective deferrals, and similar salary reduction contributions. A separate limit applies to benefits under a defined benefit plan.

For years before January 1, 2000, an overall limit applied if an employee was a participant in both a defined contribution plan and a defined benefit plan of the same employer.

### *Tax-sheltered annuities*

In the case of a tax-sheltered annuity (a "section 403(b) annuity"), the annual contribution generally cannot exceed the lesser of the exclusion allowance or the section 415(c) defined contribution limit. The exclusion allowance for a year is equal to 20% of the employee's includible compensation, multiplied by the employee's years of service, minus excludable contributions for prior years under qualified plans, tax-sheltered annuities or section 457 plans of the employer.

In addition to this general rule, employees of nonprofit educational institutions, hospitals, home health service agencies, health and welfare service agencies, and churches may elect application of one of several special rules that increase the amount of the otherwise permitted contributions. The election of a special rule is irrevocable; an employee may not elect to have more than one special rule apply.

Under one special rule, in the year the employee separates from service, the employee may elect to contribute up to the exclusion allowance, without regard to the 25% of compensation limit under section 415. Under this rule, the exclusion allowance is determined by taking into account no more than 10 years of service.

Under a second special rule, the employee may contribute up to the lesser of: (1) the exclusion allowance; (2) 25% of the participant's includible compensation; or (3) \$15,000.

Under a third special rule, the employee may elect to contribute up to the section 415(c) limit, without regard to the exclusion allowance. If this option is elected, then contributions to other plans of the employer are also taken into account in applying the limit.

For purposes of determining the contribution limits applicable to section 403(b) annuities, includible compensation means the amount of compensation received from the employer for the most recent period which may be counted as a year of service under the exclusion allowance. In addition, includible compensation includes elective deferrals and similar salary reduction amounts.

Treasury regulations include provisions regarding application of the exclusion allowance in cases where the employee participates in a section 403(b) annuity and a defined benefit plan. The Taxpayer Relief Act of 1997 directed the Secretary of the Treasury to revise these regulations, effective for years beginning after December 31, 1999, to reflect the repeal of the overall limit on contributions and benefits.

#### *Section 457 plans*

Compensation deferred under an eligible deferred compensation plan of a tax-exempt or state and local governmental employer (a "section 457 plan") is not includible in gross income until paid or made available. In general, the maximum permitted annual deferral under such a plan is the lesser of (1) \$8,500 (in 2001) or (2) 33 1/3% of compensation. The \$8,500 limit is increased for inflation in \$500 increments.

#### New Federal Law (Secs. 403(b), 415, & 457)

##### *Increase in defined contribution plan limit*

The Act increases the 25% of compensation limitation on annual additions under a defined contribution plan to 100%. Another provision of the Act increases the defined contribution plan dollar limit. The Act preserves the present-law deduction rules for money purchase pension plans. Thus, for purposes of such rules, the limitation on the amount the employer generally may deduct is an amount equal to 25% of compensation of the employees covered by the plan for the year.

It is intended that the Secretary of the Treasury will use the Secretary's existing authority to address situations where qualified nonelective contributions are targeted to certain participants with lower compensation in order to increase the average deferral percentage of nonhighly compensated employees.

For taxable years beginning after December 31, 1999, a plan may disregard the requirement that contributions to a defined benefit plan be treated as previously excluded amounts for purposes of the exclusion allowance.

##### *Conforming limits on tax-sheltered annuities*

The Act repeals the exclusion allowance applicable to contributions to tax-sheltered annuities. Thus, such annuities are subject to the limits applicable to tax-qualified plans.

The Act also directs the Secretary of the Treasury to revise the regulations relating to the exclusion allowance under section 403(b)(2) to render void the requirement that contributions to a defined benefit plan be treated as previously excluded amounts for purposes of the exclusion allowance. For taxable years beginning after December 31, 1999, the regulatory provisions regarding the exclusion allowance are to be applied as if the requirement that contributions to a defined benefit plan be treated as previously excluded amounts for purposes of the exclusion allowance were void.

### *Section 457 plans*

The Act increases the 33 1/3% of compensation limitation on deferrals under a section 457 plan to 100% of compensation.

#### Effective Date

The provision generally is effective for years beginning after December 31, 2001. The provision regarding the regulations under section 403(b)(2) is effective on June 7, 2001.

#### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
633	ENHANCING FAIRNESS FOR WOMAN - FASTER VESTING OF EMPLOYER MATCHING CONTRIBUTIONS.

#### Background

Under present law, a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100% of the participant's accrued benefit derived from employer contributions upon the completion of five years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20% of the participant's accrued benefit derived from employer contributions after three years of service, 40% after four years of service, 60% after five years of service, 80% after six years of service, and 100% after seven years of service. The minimum vesting requirements are also contained in Title I of ERISA.

#### New Federal Law (Sec. 411)

The Act applies faster vesting schedules to employer matching contributions. Under the Act, employer matching contributions are required to vest at least as rapidly as under one of the following two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100% of employer matching contributions upon the completion of three years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to 20% of employer matching contributions for each year of service beginning with the participant's second year of service and ending with 100% after six years of service.

#### Effective Date

The provision is effective for contributions for plan years beginning after December 31, 2001, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement. The provision does not apply to any employee until the employee has an hour of service after the effective date. In applying the new vesting schedule, service before the effective date is taken into account.

## California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
634	PENSION PLAN - ENHANCING FAIRNESS FOR WOMAN. MODIFICATIONS TO MINIMUM DISTRIBUTION RULES

## Background

### *In general*

Minimum distribution rules apply to all types of tax-favored retirement vehicles, including qualified plans, individual retirement arrangements ("IRAs"), tax-sheltered annuities ("section 403(b) annuities"), and eligible deferred compensation plans of tax-exempt and state and local government employers ("section 457 plans"). In general, under these rules, distribution of minimum benefits must begin no later than the required beginning date. Minimum distribution rules also apply to benefits payable with respect to a plan participant who has died. Failure to comply with the minimum distribution rules results in an excise tax imposed on the individual plan participant equal to 50% of the required minimum distribution not distributed for the year. The excise tax may be waived if the individual establishes to the satisfaction of the Commissioner that the shortfall in the amount distributed was due to reasonable error and reasonable steps are being taken to remedy the shortfall. Under certain circumstances following the death of a participant, the excise tax is automatically waived under proposed Treasury regulations.

### *Distributions prior to the death of the individual*

In the case of distributions prior to the death of the plan participant, the minimum distribution rules are satisfied if either (1) the participant's entire interest in the plan is distributed by the required beginning date, or (2) the participant's interest in the plan is to be distributed (in accordance with regulations), beginning not later than the required beginning date, over a permissible period. The permissible periods are (1) the life of the participant, (2) the lives of the participant and a designated beneficiary, (3) the life expectancy of the participant, or (4) the joint life and last survivor expectancy of the participant and a designated beneficiary. In calculating minimum required distributions, life expectancies of the participant and the participant's spouse may be recomputed annually.

In the case of qualified plans, tax-sheltered annuities, and section 457 plans, the required beginning date is the April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70½ or (2) the calendar year in which the employee retires. However, in the case of a 5% owner of the employer, distributions are required to begin no later than the April 1 of the calendar year following the year in which the 5% owner attains age 70½. If commencement of benefits is delayed beyond age 70½ from a defined benefit plan, then the accrued benefit of the employee must be actuarially increased to take into account the period after age 70½ in which the employee was not receiving benefits under the plan. State and local government plans and church plans are not required to actuarially increase benefits that begin after age 70½.

In the case of distributions from an IRA other than a Roth IRA, the required beginning date is the April 1 of the calendar year following the calendar year in which the IRA owner attains age 70½. The pre-death minimum distribution rules do not apply to Roth IRAs.

In general, under the proposed Treasury regulations, in order to satisfy the minimum distribution rules, annuity payments under a defined benefit plan must be paid in periodic payments made at intervals not longer than one year over a permissible period, and must be nonincreasing, or increase only as a result of the following: (1) cost-of-living adjustments; (2) cash refunds of employee contributions; (3) benefit increases under the plan; or (4) an adjustment due to death of the employee's beneficiary. In the case of a defined contribution plan, the minimum required distribution is determined by dividing the employee's benefit by an amount from the uniform table provided in the proposed regulations.

### New Federal Law

The Act directs the Treasury to revise the life expectancy tables under the applicable regulations to reflect current life expectancy.

### Effective Date

The provision is effective on June 7, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
635	PENSION PLAN - ENHANCING FAIRNESS FOR WOMAN - CLARIFICATION OF TAX TREATMENT OF DIVISION OF SECTION 457 PLAN BENEFITS UPON DIVORCE

### Background

Under present law, benefits provided under a qualified retirement plan for a participant may not be assigned or alienated to creditors of the participant, except in very limited circumstances. One exception to the prohibition on assignment or alienation rule is a qualified domestic relations order ("QDRO"). A QDRO is a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant, and that meets certain procedural requirements.

Under present law, a distribution from a governmental plan or a church plan is treated as made pursuant to a QDRO if it is made pursuant to a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant. Such distributions are not required to meet the procedural requirements that apply with respect to distributions from qualified plans.

Under present law, amounts distributed from a qualified plan generally are taxable to the participant in the year of distribution. However, if amounts are distributed to the spouse (or former spouse) of the participant by reason of a QDRO, the benefits are taxable to the spouse (or former spouse). Amounts distributed pursuant to a QDRO to an alternate payee other than the spouse (or former spouse) are taxable to the plan participant.

Section 457 of the Internal Revenue Code provides rules for deferral of compensation by an individual participating in an eligible deferred compensation plan ("section 457 plan") of a tax-exempt or state and local government employer. The QDRO rules do not apply to section 457 plans.

### New Federal Law (Secs. 414(p) & 457)

The Act applies the taxation rules for qualified plan distributions pursuant to a QDRO to distributions made pursuant to a domestic relations order from a section 457 plan. In addition, a section 457 plan does not violate the restrictions on distributions from such plans due to payments to an alternate payee under a QDRO. The special rule applicable to governmental plans and church plans apply for purposes of determining whether a distribution is pursuant to a QDRO.

### Effective Date

The provision is effective for transfers, distributions, and payments made after December 31, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
636	PENSION PLAN - ENHANCING FAIRNESS FOR WOMAN - PROVISIONS RELATING TO HARDSHIP WITHDRAWALS

### Background

Elective deferrals under a qualified cash or deferred arrangement (a "section 401(k) plan") may not be distributable prior to the occurrence of one or more specified events. One event upon which distribution is permitted is the financial hardship of the employee. Applicable Treasury regulations provide that a distribution is made on account of hardship only if the distribution is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the heavy need.

The Treasury regulations provide a safe harbor under which a distribution may be deemed necessary to satisfy an immediate and heavy financial need. One requirement of this safe harbor is that the employee be prohibited from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 12 months after receipt of the hardship distribution.

Under present law, hardship withdrawals of elective deferrals from a qualified cash or deferred arrangement (or 403(b) annuity) are not eligible rollover distributions. Other types of hardship distributions, e.g., employer matching contributions distributed on account of hardship, are eligible rollover distributions. Different withholding rules apply to distributions that are eligible rollover distributions and to distributions that are not eligible rollover distributions. Eligible rollover distributions that are not directly rolled over are subject to withholding at a flat rate of 20%. Distributions that are not eligible rollover distributions are subject to elective withholding. Periodic distributions are subject to withholding as if the distribution were wages; nonperiodic distributions are subject to withholding at a rate of 10%. In either case, the individual may elect not to have withholding apply.

### New Federal Law (Secs. 401(k) & 402)

The Secretary of the Treasury is directed to revise the applicable regulations to reduce from 12 months to six months the period during which an employee must be prohibited from making elective contributions and employee contributions in order for a distribution to be deemed necessary to satisfy an immediate and heavy financial need. The revised regulations are to be effective for years beginning after December 31, 2001.

In addition, any distribution made upon hardship of an employee is not an eligible rollover distribution. Thus, such distributions may not be rolled over, and are subject to the withholding rules applicable to distributions that are not eligible rollover distributions. The Act does not modify the rules under which hardship distributions may be made. For example, as under present law, hardship distributions of qualified employer matching contributions are only permitted under the rules applicable to elective deferrals.

The Act is intended to clarify that all assets distributed as a hardship withdrawal, including assets attributable to employee elective deferrals and those attributable to employer matching or nonelective contributions, are ineligible for rollover. This rule is intended to apply to all hardship distributions from any tax qualified plan, including those made pursuant to standards set forth in section 401(k)(2)(B)(i)(IV) (which are applicable to section 401(k) plans and section 403(b) annuities) and to those treated as hardship distributions under any profit-sharing plan (whether or not in accordance with the standards set forth in section 401(k)(2)(B)(i)(IV)). For this purpose, a distribution that could be made either under the hardship provisions of a plan or under other provisions of the plan (such as provisions permitting in-service withdrawal of assets attributable to employer matching or nonelective contributions after a fixed period of years) could be treated as made upon hardship of the employee if the plan treats it that way. For example, if a plan makes an in-service distribution that consists of assets attributable to both elective deferrals (in circumstances where those assets could be distributed only upon hardship) and employer matching or nonelective contributions (which could be distributed in nonhardship circumstances under the plan), the plan is permitted to treat the distribution in its entirety as made upon hardship of the employee.

### Effective Date

The provision directing the Secretary to revise the rules relating to safe harbor hardship distributions is effective on June 7, 2001. The provision that hardship distributions are not eligible rollover distributions is effective for distributions made after December 31, 2001. The Secretary has the authority to issue transitional guidance with respect to the provision that hardship distributions are not eligible rollover distributions to provide sufficient time for plans to implement the new rule.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.



<u>Section</u>	<u>Section Title</u>
637	ENHANCING FAIRNESS FOR WOMAN - PENSION COVERAGE FOR DOMESTIC AND SIMILAR WORKERS

### Background

Under present law, within limits, employers may make deductible contributions to qualified retirement plans for employees. Subject to certain exceptions, a 10% excise tax applies to nondeductible contributions to such plans.

Employers of household workers may establish a pension plan for their employees. Contributions to such plans are not deductible because they are not made in connection with a trade or business of the employer.

### New Federal Law (Sec. 4972(c)(6))

The 10% excise tax on nondeductible contributions does not apply to contributions to a SIMPLE plan or a SIMPLE IRA that are nondeductible solely because the contributions are not a trade or business expense under section 162 because they are not made in connection with a trade or business of the employer. Thus, for example, employers of household workers are able to make contributions to such plans without imposition of the excise tax. As under present law, the contributions are not deductible. The present-law rules applicable to such plans, e.g., contribution limits and nondiscrimination rules, continue to apply. The Act does not apply with respect to contributions on behalf of the individual and members of his or her family.

No inference is intended with respect to the application of the excise tax under present law to contributions that are not deductible because they are not made in connection with a trade or business of the employer.

As under present law, a plan covering domestic workers is not qualified unless the coverage rules are satisfied by aggregating all employees of family members taken into account under the attribution rules in section 414(c), but disregarding employees employed by a controlled group of corporations or a trade or business.

It is intended that the Act is restricted to contributions made by employers of household workers with respect to whom all applicable employment taxes have been and are being paid.

### Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

### California Law

California law is in conformity, with minor modifications, with federal law as it read on January 1, 1998, as it relates to pension plans. California's early withdrawal on IRA distributions penalty is 2.5%, as opposed to the 10% federal rate. California law has not conformed to the changes made to the IRC by the EGTRRA.

<u>Section</u>	<u>Section Title</u>
641-643	PENSION PLAN - ROLLOVERS OF RETIREMENT PLAN AND IRA DISTRIBUTIONS.

Background

Present law permits the rollover of funds from a tax-favored retirement plan to another tax-favored retirement plan. The rules that apply depend on the type of plan involved. Similarly, the rules regarding the tax treatment of amounts that are not rolled over depend on the type of plan involved.

*Distributions from qualified plans*

Under present law, an “eligible rollover distribution” from a tax-qualified employer-sponsored retirement plan may be rolled over tax free to a traditional individual retirement arrangement (“IRA”) (All references to IRAs refer only to traditional IRAs. A “traditional” IRA refers to IRAs other than Roth IRAs or SIMPLE) or another qualified plan). An eligible rollover distribution may either be rolled over by the distributee within 60 days of the date of the distribution or, as described below, directly rolled over by the distributing plan. An “eligible rollover distribution” means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan, except the term does not include (1) any distribution which is one of a series of substantially equal periodic payments made (a) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or (b) for a specified period of 10 years or more, (2) any distribution to the extent such distribution is required under the minimum distribution rules, and (3) certain hardship distributions. The maximum amount that can be rolled over is the amount of the distribution includible in income, i.e., after-tax employee contributions cannot be rolled over. Qualified plans are not required to accept rollovers.

*Distributions from tax-sheltered annuities*

Eligible rollover distributions from a tax-sheltered annuity (“section 403(b) annuity”) may be rolled over into an IRA or another section 403(b) annuity. Distributions from a section 403(b) annuity cannot be rolled over into a tax-qualified plan. Section 403(b) annuities are not required to accept rollovers.

*IRA distributions*

Distributions from a traditional IRA, other than minimum required distributions, can be rolled over into another IRA. In general, distributions from an IRA cannot be rolled over into a qualified plan or section 403(b) annuity. An exception to this rule applies in the case of so-called “conduit IRAs.” Under the conduit IRA rule, amounts can be rolled from a qualified plan into an IRA and then subsequently rolled back to another qualified plan if the amounts in the IRA are attributable solely to rollovers from a qualified plan. Similarly, an amount may be rolled over from a section 403(b) annuity to an IRA and subsequently rolled back into a section 403(b) annuity if the amounts in the IRA are attributable solely to rollovers from a section 403(b) annuity.

*Distributions from section 457 plans*

A “section 457 plan” is an eligible deferred compensation plan of a state or local government or tax-exempt employer that meets certain requirements. In some cases, different rules apply under section 457 to governmental plans and plans of tax-exempt employers. For example, governmental section 457 plans are like qualified plans in that plan assets are required to be held in a trust for the exclusive benefit of plan participants and beneficiaries. In contrast, benefits under a section 457 plan of a tax-exempt employer are unfunded, like nonqualified deferred compensation plans of private employers.

Section 457 benefits can be transferred to another section 457 plan. Distributions from a section 457 plan cannot be rolled over to another section 457 plan, a qualified plan, a section 403(b) annuity, or an IRA.

#### *Rollovers by surviving spouses*

A surviving spouse that receives an eligible rollover distribution may roll over the distribution into an IRA, but not a qualified plan or section 403(b) annuity.

#### *Direct rollovers and withholding requirements*

Qualified plans and section 403(b) annuities are required to provide that a plan participant has the right to elect that an eligible rollover distribution be directly rolled over to another eligible retirement plan. If the plan participant does not elect the direct rollover option, then withholding is required on the distribution at a 20% rate. Distributions from qualified plans and section 403(b) annuities that are not eligible rollover distributions are subject to elective withholding. Periodic distributions are subject to withholding as if the distribution were wages; nonperiodic distributions are subject to withholding at a rate of 10%. In either case, the individual may elect not to have withholding apply.

#### *Notice of eligible rollover distribution*

The plan administrator of a qualified plan or a section 403(b) annuity is required to provide a written explanation of rollover rules to individuals who receive a distribution eligible for rollover. In general, the notice is to be provided within a reasonable period of time before making the distribution and is to include an explanation of (1) the provisions under which the individual may have the distribution directly rolled over to another eligible retirement plan, (2) the provision that requires withholding if the distribution is not directly rolled over, (3) the provision under which the distribution may be rolled over within 60 days of receipt, and (4) if applicable, certain other rules that may apply to the distribution. The Treasury Department has provided more specific guidance regarding timing and content of the notice.

#### *Taxation of distributions*

As is the case with the rollover rules, different rules regarding taxation of benefits apply to different types of tax-favored arrangements. In general, distributions from a qualified plan, section 403(b) annuity, or IRA are includible in income in the year received. In certain cases, distributions from qualified plans are eligible for capital gains treatment and averaging. These rules do not apply to distributions from another type of plan. Distributions from a qualified plan, IRA, and section 403(b) annuity generally are subject to an additional 10% early withdrawal tax if made before age 59½. There are a number of exceptions to the early withdrawal tax. Some of the exceptions apply to all three types of plans, and others apply only to certain types of plans. For example, the 10% early withdrawal tax does not apply to IRA distributions for educational expenses, but does apply to similar distributions from qualified plans and section 403(b) annuities. Benefits under a section 457 plan are generally includible in income when paid or made available. The 10% early withdrawal tax does not apply to section 457 plans.

New Federal Law (Sec. 401, 402, 403(b), 408, 457, & 3405)

*In general*

The Act provides that eligible rollover distributions from qualified retirement plans, section 403(b) annuities, and governmental section 457 plans generally could be rolled over to any of such plans or arrangements. Hardship distributions from governmental section 457 plans would not be considered eligible rollover distributions.

Similarly, distributions from an IRA generally are permitted to be rolled over into a qualified plan, section 403(b) annuity, or governmental section 457 plan. The direct rollover and withholding rules are extended to distributions from a governmental section 457 plan, and such plans are required to provide the written notification regarding eligible rollover distributions. The elective withholding rules applicable to distributions from qualified plans and section 403(b) annuities that are not eligible rollover distributions are also extended to distributions from governmental section 457 plans. Thus, periodic distributions from governmental section 457 plans that are not eligible rollover distributions are subject to withholding as if the distribution were wages and nonperiodic distributions from such plans that are not eligible rollover distributions are subject to withholding at a 10% rate. In either case, the individual may elect not to have withholding apply. The rollover notice (with respect to all plans) is required to include a description of the provisions under which distributions from the plan to which the distribution is rolled over may be subject to restrictions and tax consequences different than those applicable to distributions from the distributing plan. Qualified plans, section 403(b) annuities, and section 457 plans would not be required to accept rollovers.

Some special rules apply in certain cases. A distribution from a qualified plan is not eligible for capital gains or averaging treatment if there was a rollover to the plan that would not have been permitted under present law. Thus, in order to preserve capital gains and averaging treatment for a qualified plan distribution that is rolled over; the rollover would have to be made to a "conduit IRA" as under present law, and then rolled back into a qualified plan. Amounts distributed from a section 457 plan are subject to the early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from another type of plan. Section 457 plans are required to separately account for such amounts.

*Rollover of after-tax contributions*

The Act provides that employee after-tax contributions may be rolled over into another qualified plan or a traditional IRA. In the case of a rollover from a qualified plan to another qualified plan, the rollover is permitted to be accomplished only through a direct rollover. In addition, a qualified plan is not permitted to accept rollovers of after-tax contributions unless the plan provides separate accounting for such contributions (and earnings thereon). After-tax contributions (including nondeductible contributions to an IRA) are not permitted to be rolled over from an IRA into a qualified plan, tax-sheltered annuity, or section 457 plan.

In the case of a distribution from a traditional IRA that is rolled over into an eligible rollover plan that is not an IRA, the distribution is attributed first to amounts other than after-tax contributions.

*Expansion of spousal rollovers*

The Act provides that surviving spouses may roll over distributions to a qualified plan, section 403(b) annuity, or governmental section 457 plan in which the surviving spouse participates.

### *Treasury regulations*

The Secretary is directed to prescribe rules necessary to carry out the Act. Such rules may include, for example, reporting requirements and mechanisms to address mistakes relating to rollovers. It is anticipated that the IRS will develop forms to assist individuals who roll over after-tax contributions to an IRA in keeping track of such contributions. Such forms could, for example, expand Form 8606--Nondeductible IRAs, to include information regarding after-tax contributions.

### Effective Date

The provision is effective for distributions made after December 31, 2001. It is intended that the Secretary will revise the safe harbor rollover notice that plans may use to satisfy the rollover requirements. No penalty is imposed on a plan for a failure to provide the information required under the Act with respect to any distribution made before the date that is 90 days after the date the Secretary issues a new safe harbor rollover notice, if the plan administrator makes a reasonable attempt to comply with such notice requirement. For example, the Act requires that the rollover notice include a description of the provisions under which distributions from the eligible retirement plan receiving the distribution may be subject to restrictions and tax consequences which are different from those applicable to distributions from the plan making the distribution. A plan is treated as making a reasonable good faith effort to comply with this requirement if the notice states that distributions from the plan to which the rollover is made may be subject to different restrictions and tax consequences than those that apply to distributions from the plan from which the rollover is made.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to rollovers of pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
644	PENSION PLAN - WAIVER OF 60-DAY RULE.

### Background

Under present law, amounts received from an IRA or qualified plan may be rolled over tax free if the rollover is made within 60 days of the date of the distribution. The Secretary does not have the authority to waive the 60-day requirement, except during military service in a combat zone or by reason of a Presidentially declared disaster. The Secretary has issued regulations postponing the 60-day rule in such cases.

### New Federal Law (Secs. 402 & 408)

The Act provides that the Secretary may waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement. For example, the Secretary may issue guidance that includes objective standards for a waiver of the 60-day rollover period, such as waiving the rule due to military service in a combat zone or during a Presidentially declared disaster (both of which are provided for under present law), or for a period during which the participant has received payment in the form of a check, but has not cashed the check, or for errors committed by a financial institution, or in cases of inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, or postal error.

### Effective Date

The provision applies to distributions made after December 31, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the 60-day rule for pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
645	PENSION PLAN - TREATMENT OF FORMS OF DISTRIBUTION.

### Background

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant. An amendment is treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit (sec. 411(d)(6)). A similar provision is contained in Title I of ERISA.

Under regulations recently issued by the Secretary, this prohibition against the elimination of an optional form of benefit does not apply in the case of (1) a defined contribution plan that offers a lump sum at the same time as the form being eliminated if the participant receives at least 90 days' advance notice of the elimination, or (2) a voluntary transfer between defined contribution plans, subject to the requirements that a transfer from a money purchase pension plan, an ESOP, or a section 401(k) plan must be to a plan of the same type and that the transfer be made in connection with certain corporate mergers, acquisitions, or similar transactions or changes in employment status

### New Federal Law (Sec. 411(d)(6))

A defined contribution plan to which benefits are transferred will not be treated as reducing a participant's or beneficiary's accrued benefit even though it does not provide all of the forms of distribution previously available under the transferor plan if (1) the plan receives from another defined contribution plan a direct transfer of the participant's or beneficiary's benefit accrued under the transferor plan, or the plan results from a merger or other transaction that has the effect of a direct transfer (including consolidations of benefits attributable to different employers within a multiple employer plan), (2) the terms of both the transferor plan and the transferee plan authorize the transfer, (3) the transfer occurs pursuant to a voluntary election by the participant or beneficiary that is made after the participant or beneficiary received a notice describing the consequences of making the election, and (4) the transferee plan allows the participant or beneficiary to receive distribution of his or her benefit under the transferee plan in the form of a single sum distribution. The Act does not modify the rules relating to survivor annuities under section 417. Thus, as under present law, a plan that is a transferee of a plan subject to the joint and survivor rules is also subject to those rules.

Except to the extent provided by the Secretary of the Treasury in regulations, a defined contribution plan is not treated as reducing a participant's accrued benefit if (1) a plan amendment eliminates a form of distribution previously available under the plan, (2) a single sum distribution is available to the participant at the same time or times as the form of distribution eliminated by the amendment, and (3) the single sum distribution is based on the same or greater portion of the participant's accrued benefit as the form of distribution eliminated by the amendment.

Furthermore, the Act directs the Secretary of the Treasury to provide by regulations that the prohibitions against eliminating or reducing an early retirement benefit, a retirement-type subsidy, or an optional form of benefit do not apply to plan amendments that eliminate or reduce early retirement benefits, retirement-type subsidies, and optional forms of benefit that create significant burdens and complexities for a plan and its participants, but only if such an amendment does not adversely affect the rights of any participant in more than a de minimis manner.

It is intended that the factors to be considered in determining whether an amendment has more than a de minimis adverse effect on any participant will include (1) all of the participant's early retirement benefits, retirement-type subsidies, and optional forms of benefits that are reduced or eliminated by the amendment, (2) the extent to which early retirement benefits, retirement-type subsidies, and optional forms of benefit in effect with respect to a participant after the amendment effective date provide rights that are comparable to the rights that are reduced or eliminated by the plan amendment, (3) the number of years before the participant attains normal retirement age under the plan (or early retirement age, as applicable), (4) the size of the participant's benefit that is affected by the plan amendment, in relation to the amount of the participant's compensation, and (5) the number of years before the plan amendment is effective.

This provision does not affect the rules relating to involuntary cash outs (sec. 411(a)(11)) or survivor annuity requirements (sec. 417). Accordingly, if a participant is entitled to protections of the joint and survivor rules, those protections may not be eliminated. The intent of the provision authorizing regulations is solely to permit the elimination of early retirement benefits, retirement-type subsidies, or optional forms of benefit that have no more than a de minimis effect on any participant but create disproportionate burdens and complexities for a plan and its participants.

For example, assume the following. Employer A acquires employer B and merges B's defined benefit plan into A's defined benefit plan. The defined benefit plan maintained by B before the merger provides an early retirement subsidy for individuals age 55 with a specified number of years of service. E1 and E2 are employees of B and who transfer to A in connection with the merger. E1 is 25 years old and has compensation of \$40,000. The present value of E1's early retirement subsidy under B's plan is \$75. E2 is 50 years old and also has compensation of \$40,000. The present value of E2's early retirement subsidy under B's plan is \$10,000.

Assume that A's plan has an early retirement subsidy for individuals who have attained age 50 with a specified number of years of service, but the subsidy is not the same as under B's plan. Under A's plan, the present value of E2's early retirement subsidy is \$9,850. Maintenance of both subsidies after the plan merger would create burdens for the plan and complexities for the plan and its participants.

Treasury regulations could permit E1's early retirement subsidy under B's plan to be eliminated entirely (i.e., even if A's plan did not have an early retirement subsidy). Taking into account all relevant factors, including the value of the benefit, E1's compensation, and the number of years until E1 would be eligible to receive the subsidy, the subsidy is de minimis. Treasury regulations could permit E2's early retirement subsidy under B's plan to be eliminated as to be replaced by the subsidy under A's plan, because the difference in the subsidies is de minimis.

However, A's subsidy could not be entirely eliminated. The Secretary is directed to issue, not later than December 31, 2003, final regulations under section 411(d)(6), including regulations required under the Act.

#### Effective Date

The provision is effective for years beginning after December 31, 2001, except that the direction to the Secretary is effective on June 7, 2001.

#### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
646	PENSION PLAN - RATIONALIZATION OF RESTRICTIONS ON DISTRIBUTIONS

#### Background

Elective deferrals under a qualified cash or deferred arrangement ("section 401(k) plan"), tax-sheltered annuity ("section 403(b) annuity"), or an eligible deferred compensation plan of a tax-exempt organization or state or local government ("section 457 plan"), may not be distributable prior to the occurrence of one or more specified events. These permissible distributable events include "separation from service."

A separation from service occurs only upon a participant's death, retirement, resignation or discharge, and not when the employee continues on the same job for a different employer as a result of the liquidation, merger, consolidation or other similar corporate transaction. A severance from employment occurs when a participant ceases to be employed by the employer that maintains the plan. Under a so-called "same desk rule," a participant's severance from employment does not necessarily result in a separation from service.

In addition to separation from service and other events, a section 401(k) plan that is maintained by a corporation may permit distributions to certain employees who experience a severance from employment with the corporation that maintains the plan but do not experience a separation from service because the employees continue on the same job for a different employer as a result of a corporate transaction. If the corporation disposes of substantially all of the assets used by the corporation in a trade or business, a distributable event occurs with respect to the accounts of the employees who continue employment with the corporation that acquires the assets. If the corporation disposes of its interest in a subsidiary, a distributable event occurs with respect to the accounts of the employees who continue employment with the subsidiary. Under a recent IRS ruling, a person is generally deemed to have separated from service if that person is transferred to another employer in connection with a sale of less than substantially all the assets of a trade or business.

#### New Federal Law (Secs. 401(k), 403(b), & 457)

The Act modifies the distribution restrictions applicable to section 401(k) plans, section 403(b) annuities, and section 457 plans to provide that distribution may occur upon severance from employment rather than separation from service. In addition, the provisions for distribution from a section 401(k) plan based upon a corporation's disposition of its assets or a subsidiary are repealed; this special rule is no longer necessary under the Act.



It is intended that a plan may provide that certain specified types of severance from employment do not constitute distributable events. For example, a plan could provide that a severance from employment is not a distributable event if it would not have constituted a "separation from service" under the law in effect prior to a specified date. Also, if a plan describes distributable events by reference to section 401(k)(2), the plan may be amended to restrict distributable events to fewer than all events that constitute a severance from employment. Thus, for example, if a plan sponsor had employees who experienced a severance from employment in the past that the "same desk rule" prevented from being treated as a distributable event, the plan sponsor would have the option of providing in the plan that such severance from employment would, or would not, be treated as a distributable event under the plan.

It is also intended that, as under current law, if there is a transfer of plan assets and liabilities relating to any portion of an employee's benefit under a plan of the employee's former employer to a plan being maintained or created by the employee's new employer (other than a rollover or elective transfer), then that employee has not experienced a severance from employment with the employer maintaining the plan that covers the employee.

#### Effective Date

The provision is effective for distributions after December 31, 2001, regardless of when the severance of employment occurred.

#### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
647	PURCHASE OF SERVICE CREDIT UNDER GOVERNMENTAL PENSION PLANS.

#### Background

A qualified retirement plan maintained by a state or local government employer may provide that a participant may make after-tax employee contributions in order to purchase permissive service credit, subject to certain limits (sec. 415). Permissive service credit means credit for a period of service recognized by the governmental plan only if the employee voluntarily contributes to the plan an amount (as determined by the plan) that does not exceed the amount necessary to fund the benefit attributable to the period of service and that is in addition to the regular employee contributions, if any, under the plan.

In the case of any repayment of contributions and earnings to a governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan (or another plan maintained by a state or local government employer within the same state), any such repayment is not taken into account for purposes of the section 415 limits on contributions and benefits. Also, service credit obtained as a result of such a repayment is not considered permissive service credit for purposes of the section 415 limits. A participant may not use a rollover or direct transfer of benefits from a tax-sheltered annuity ("section 403(b) annuity") or an eligible deferred compensation plan of a tax-exempt organization or a state or local government ("section 457 plan") to purchase permissive service credits or repay contributions and earnings with respect to a forfeiture of service credit.

### New Federal Law (Secs. 403(b) & 457)

A participant in a state or local governmental plan is not required to include in gross income a direct trustee-to-trustee transfer to a governmental defined benefit plan from a section 403(b) annuity or a section 457 plan if the transferred amount is used (1) to purchase permissive service credits under the plan, or (2) to repay contributions and earnings with respect to an amount previously refunded under a forfeiture of service credit under the plan (or another plan maintained by a state or local government employer within the same state).

#### Effective Date

The provision is effective for transfers after December 31, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
648	PENSION PLAN - EMPLOYERS MAY DISREGARD ROLLOVERS FOR PURPOSES OF CASH-OUT RULES

#### Background

If a qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed \$5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which a benefit was involuntarily distributed unless the employee repays the benefit.

Generally, a participant may roll over an involuntary distribution from a qualified plan to an IRA or to another qualified plan. Other Act provisions expand the kinds of plans to which benefits may be rolled over.

### New Federal Law (Sec. 411(a)(11))

For purposes of the cash-out rule, a plan is permitted to provide that the present value of a participant's nonforfeitable accrued benefit is determined without regard to the portion of such benefit that is attributable to rollover contributions (and any earnings allocable thereto).

#### Effective Date

The provision is effective for distributions after December 31, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
649	MINIMUM DISTRIBUTION AND INCLUSION REQUIREMENTS FOR SECTION 457 PLANS.

Background

A "section 457 plan" is an eligible deferred compensation plan of a state or local government or tax-exempt employer that meets certain requirements. For example, amounts deferred under a section 457 plan cannot exceed certain limits. Amounts deferred under a section 457 plan are generally includible in income when paid or made available. Amounts deferred under a plan of deferred compensation of a state or local government or tax-exempt employer that does not meet the requirements of section 457 are includible in income when the amounts are not subject to a substantial risk of forfeiture, regardless of whether the amounts have been paid or made available. This rule of inclusion does not apply to amounts deferred under a tax-qualified retirement plan or similar plans.

Section 457 plans are subject to the minimum distribution rules applicable to tax-qualified pension plans. In addition, such plans are subject to additional minimum distribution rules (sec. 457(d)(2)(B)).

New Federal Law (Sec. 457)

The Act provides that amounts deferred under a section 457 plan of a state or local government are includible in income when paid. The Act also repeals the special minimum distribution rules applicable to section 457 plans. Thus, such plans are subject to the minimum distribution rules applicable to qualified plans.

Effective Date

The provision is effective for distributions after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
651-652	PHASE IN REPEAL OF 160% OF CURRENT LIABILITY FUNDING LIMIT; DEDUCTION FOR CONTRIBUTIONS TO FUND TERMINATION LIABILITY

Background

Under present law, defined benefit pension plans are subject to minimum funding requirements designed to ensure that pension plans have sufficient assets to pay benefits. A defined benefit pension plan is funded using one of a number of acceptable actuarial cost methods.

No contribution is required under the minimum funding rules in excess of the full funding limit. The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 160% of the plan's current liability, over (2) the value of the plan's assets (sec. 412(c)(7)). In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits. The current liability full funding limit is scheduled to increase as follows: 165% for plan years beginning in 2003 and 2004, and 170% for plan years beginning in 2005 and thereafter. In no event is a plan's full funding limit less than 90% of the plan's current liability over the value of the plan's assets.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Under a special rule, an employer that sponsors a defined benefit pension plan (other than a multiemployer plan) which has more than 100 participants for the plan year may deduct amounts contributed of up to 100% of the plan's unfunded current liability.

#### New Federal Law (Secs. 404(a)(1), 412(c)(7), & 4972(c))

##### *Current liability full funding limit*

The Act gradually increases and then repeals the current liability full funding limit. Under the Act, the current liability full funding limit is 165% of current liability for plan years beginning in 2002, and 170% for plan years beginning in 2003. The current liability full funding limit is repealed for plan years beginning in 2004 and thereafter. Thus, in 2004 and thereafter, the full funding limit is the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the value of the plan's assets.

##### *Deduction for contributions to fund termination liability*

The special rule allowing a deduction for unfunded current liability generally is extended to all defined benefit pension plans, i.e., the Act applies to multiemployer plans and plans with 100 or fewer participants. The special rule does not apply to plans not covered by the PBGC termination insurance program. The PBGC termination insurance program does not cover plans of professional service employers that have fewer than 25 participants. The Act also modifies the rule by providing that the deduction is for up to 100% of unfunded termination liability, determined as if the plan terminated at the end of the plan year. In the case of a plan with less than 100 participants for the plan year, termination liability does not include the liability attributable to benefit increases for highly compensated employees resulting from a plan amendment which was made or became effective, whichever is later, within the last two years. This rule to provide that the deduction is for up to 100% of unfunded termination liability is applicable only for a plan that terminates within the plan year.

#### Effective Date

The provision is effective for plan years beginning after December 31, 2001.

#### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

<u>Section</u>	<u>Section Title</u>
654	PENSION PLAN - MODIFICATIONS TO SECTION 415 LIMITS FOR MULTIEMPLOYER PLANS.

### Background

Under present law, limits apply to contributions and benefits under qualified plans (sec. 415). The limits on contributions and benefits under qualified plans are based on the type of plan. Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) 100% of average compensation for the highest three years, or (2) \$140,000 (for 2001). The dollar limit is adjusted for cost-of-living increases in \$5,000 increments. The dollar limit is reduced in the case of retirement before the social security retirement age and increases in the case of retirement after the social security retirement age

A special rule applies to governmental defined benefit plans. In the case of such plans, the defined benefit dollar limit is reduced in the case of retirement before age 62 and increased in the case of retirement after age 65. In addition, there is a floor on early retirement benefits. Pursuant to this floor, the minimum benefit payable at age 55 is \$75,000.

In the case of a defined contribution plan, the limit on annual additions is the lesser of (1) 25% of compensation or (2) \$35,000 (for 2001). Another provision of the Act increases this limit to 100% of compensation.

In applying the limits on contributions and benefits, plans of the same employer are aggregated. That is, all defined benefit plans of the same employer are treated as a single plan, and all defined contribution plans of the same employer are treated as a single plan. Under Treasury regulations, multiemployer plans are not aggregated with other multiemployer plans. However, if an employer maintains both a plan that is not a multiemployer plan and a multiemployer plan, the plan that is not a multiemployer plan is aggregated with the multiemployer plan to the extent that benefits provided under the multiemployer plan are provided with respect to a common participant.

### New Federal Law (Sec. 415)

Under the Act, the 100% of compensation defined benefit plan limit does not apply to multiemployer plans. With respect to aggregation of multiemployer plans with other plans, the Act provides that multiemployer plans are not aggregated with single-employer defined benefit plans maintained by an employer contributing to the multiemployer plan for purposes of applying the 100% of compensation limit to such single-employer plan.

### Effective Date

The provision is effective for years beginning after December 31, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

<u>Section</u>	<u>Section Title</u>
655	PENSION PLAN - INVESTMENT OF EMPLOYEE CONTRIBUTIONS IN 401(K) PLANS

### Background

The Employee Retirement Income Security Act of 1974, as amended ("ERISA") prohibits certain employee benefit plans from acquiring securities or real property of the employer who sponsors the plan if, after the acquisition, the fair market value of such securities and property exceeds 10% of the fair market value of plan assets. The 10% limitation does not apply to any "eligible individual account plans" that specifically authorize such investments. Generally, eligible individual account plans are defined contribution plans, including plans containing a cash or deferred arrangement ("401(k) plans").

The term "eligible individual account plan" does not include the portion of a plan that consists of elective deferrals (and earnings on the elective deferrals) made under section 401(k) if elective deferrals equal to more than 1% of any employee's eligible compensation are required to be invested in employer securities and employer real property. Eligible compensation is compensation that is eligible to be deferred under the plan. The portion of the plan that consists of elective deferrals (and earnings thereon) is still treated as an individual account plan, and the 10% limitation does not apply, as long as elective deferrals (and earnings thereon) are not required to be invested in employer securities or employer real property. The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan does not apply if individual account plans are a small part of the employer's retirement plans. In particular, that rule does not apply to an individual account plan for a plan year if the value of the assets of all individual account plans maintained by the employer do not exceed 10% of the value of the assets of all pension plans maintained by the employer (determined as of the last day of the preceding plan year). Multiemployer plans are not taken into account in determining whether the value of the assets of all individual account plans maintained by the employer exceed 10% of the value of the assets of all pension plans maintained by the employer.

The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan does not apply to an employee stock ownership plan as defined in section 4975(e)(7) of the Internal Revenue Code.

The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan applies to elective deferrals for plan years beginning after December 31, 1998 (and earnings thereon). It does not apply with respect to earnings on elective deferrals for plan years beginning before January 1, 1999.

### New Federal Law (Sec. 1524(b) of the Taxpayer Relief Act of 1997)

The Act modifies the effective date of the rule excluding certain elective deferrals (and earnings thereon) from the definition of individual account plan by providing that the rule does not apply to any elective deferral used to acquire an interest in the income or gain from employer securities or employer real property acquired (1) before January 1, 1999, or (2) after such date pursuant to a written contract which was binding on such date and at all times thereafter.

### Effective Date

The provision is effective as if included in the section of the Taxpayer Relief Act of 1997 that contained the rule excluding certain elective deferrals (and earnings thereon).

## California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
656	PROHIBITED ALLOCATIONS OF STOCK IN AN S CORPORATION ESOP.

## Background

The Small Business Job Protection Act of 1996 allowed qualified retirement plan trusts described in section 401(a) to own stock in an S corporation. That Act treated the plan's share of the S corporation's income (and gain on the disposition of the stock) as includible in full in the trust's unrelated business taxable income ("UBTI").

The Tax Relief Act of 1997 repealed the provision treating items of income or loss of an S corporation as UBTI in the case of an employee stock ownership plan ("ESOP"). Thus, the income of an S corporation allocable to an ESOP is not subject to current taxation.

Present law provides a deferral of income on the sales of certain employer securities to an ESOP (sec. 1042). A 50% excise tax is imposed on certain prohibited allocations of securities acquired by an ESOP in a transaction to which section 1042 applies. In addition, such allocations are currently includible in the gross income of the individual receiving the prohibited allocation.

## New Federal Law (Secs. 409 & 4979a)

### *In general*

Under the Act, if there is a nonallocation year with respect to an ESOP maintained by an S corporation: (1) the amount allocated in a prohibited allocation to an individual who is a disqualified person is treated as distributed to such individual (i.e., the value of the prohibited allocation is includible in the gross income of the individual receiving the prohibited allocation); (2) an excise tax is imposed on the S corporation equal to 50% of the amount involved in a prohibited allocation; and (3) an excise tax is imposed on the S corporation with respect to any synthetic equity owned by a disqualified person. The plan is not disqualified merely because an excise tax is imposed under the provision.

It is intended that the Act will limit the establishment of ESOPs by S corporations to those that provide broad-based employee coverage and that benefit rank-and-file employees as well as highly compensated employees and historical owners.

*Definition of nonallocation year*

A nonallocation year means any plan year of an ESOP holding shares in an S corporation if, at any time during the plan year, disqualified persons own at least 50% of the number of outstanding shares of the S corporation.

A person is a disqualified person if the person is either (1) a member of a “deemed 20% shareholder group” or (2) a “deemed 10% shareholder.” A person is a member of a “deemed 20% shareholder group” if the aggregate number of deemed-owned shares of the person and his or her family members is at least 20% of the number of deemed-owned shares of stock in the S corporation. A person is a deemed 10% shareholder if the person is not a member of a deemed 20% shareholder group and the number of the person's deemed-owned shares is at least 10% of the number of deemed-owned shares of stock of the corporation. A family member of a member of a “deemed 20% shareholder group” with deemed owned shares is also treated as a disqualified person.

In general, “deemed-owned shares” means: (1) stock allocated to the account of an individual under the ESOP, and (2) an individual's share of unallocated stock held by the ESOP. An individual's share of unallocated stock held by an ESOP is determined in the same manner as the most recent allocation of stock under the terms of the plan. For purposes of determining whether there is a nonallocation year, ownership of stock generally is attributed under the rules of section 318. These attribution rules also apply to stock treated as owned by reason of the ownership of synthetic equity, except that: (1) the family attribution rules are modified to include certain other family members, as described below, (2) option attribution does not apply (but instead special rules relating to synthetic equity described below apply), and (3) “deemed-owned shares” held by the ESOP are treated as held by the individual with respect to whom they are deemed owned.

Under the provision, family members of an individual include (1) the spouse of the individual, (2) an ancestor or lineal descendant of the individual or his or her spouse, (3) a sibling of the individual (or the individual's spouse) and any lineal descendant of the brother or sister, and (4) the spouse of any person described in (2) or (3).

The Act contains special rules applicable to synthetic equity interests. Except to the extent provided in regulations, the stock on which a synthetic equity interest is based are treated as outstanding stock of the S corporation and as deemed-owned shares of the person holding the synthetic equity interest if such treatment will result in the treatment of any person as a disqualified person or the treatment of any year as a nonallocation year. Thus, for example, disqualified persons for a year include those individuals who are disqualified persons under the general rule (i.e., treating only those shares held by the ESOP as deemed-owned shares) and those individuals who are disqualified individuals if synthetic equity interests are treated as deemed-owned shares.

“Synthetic equity” means any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest that gives the holder the right to acquire or receive stock of the S corporation in the future. Except to the extent provided in regulations, synthetic equity also includes a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value. The provisions relating to synthetic equity do not modify the rules relating to S corporations, e.g., the circumstances in which options or similar interests are treated as creating a second class of stock.

Ownership of synthetic equity is attributed in the same manner as stock is attributed under the Act (as described above). In addition, ownership of synthetic equity is attributed under the rules of section 318(a)(2) and (3) in the same manner as stock.



### *Definition of prohibited allocation*

An ESOP of an S corporation is required to provide that no portion of the assets of the plan attributable to (or allocable in lieu of) S corporation stock may, during a nonallocation year, accrue (or be allocated directly or indirectly under any qualified plan of the S corporation) for the benefit of a disqualified person. A “prohibited allocation” refers to violations of this provision. A prohibited allocation occurs, for example, if income on S corporation stock held by an ESOP is allocated to the account of an individual who is a disqualified person.

### *Application of excise tax*

In the case of a prohibited allocation, the S corporation is liable for an excise tax equal to 50% of the amount of the allocation. For example, if S corporation stock is allocated in a prohibited allocation, the excise tax is equal to 50% of the fair market value of such stock.

A special rule applies in the case of the first nonallocation year, regardless of whether there is a prohibited allocation. In that year, the excise tax also applies to the fair market value of the deemed-owned shares of any disqualified person held by the ESOP, even though those shares are not allocated to the disqualified person in that year. As mentioned above, the S corporation also is liable for an excise tax with respect to any synthetic equity interest owned by any disqualified person in a nonallocation year. The excise tax is 50% of the value of the shares on which synthetic equity is based.

### *Treasury regulations*

The Treasury Department is given the authority to prescribe such regulations as may be necessary to carry out the purposes of the Act.

The Act authorizes the Secretary to determine, by regulation or other guidance of general applicability, that a nonallocation year occurs in any case in which the principal purpose of the ownership structure of an S corporation constitutes, in substance, an avoidance or evasion of the prohibited allocation rules. For example, this might apply if more than 10 independent businesses are combined in an S corporation owned by an ESOP in order to take advantage of the income tax treatment of S corporations owned by an ESOP.

### Effective Date

The provision generally is effective with respect to plan years beginning after December 31, 2004. In the case of an ESOP established after March 14, 2001, or an ESOP established on or before such date if the employer maintaining the plan was not an S corporation on such date, the provision is effective with respect to plan years ending after March 14, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
657	PENSION PLAN - AUTOMATIC ROLLOVERS OF CERTAIN MANDATORY DISTRIBUTIONS.

Background

If a qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed \$5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which a benefit was involuntarily distributed unless the employee repays the benefit.

Generally, a participant may roll over an involuntary distribution from a qualified plan to an IRA or to another qualified plan. Before making a distribution that is eligible for rollover, a plan administrator must provide the participant with a written explanation of the ability to have the distribution rolled over directly to an IRA or another qualified plan and the related tax consequences.

New Federal Law (Sec. 404(c) of ERISA)

The Act makes a direct rollover the default option for involuntary distributions that exceed \$1,000 and that are eligible rollover distributions from qualified retirement plans. The distribution must be rolled over automatically to a designated IRA, unless the participant affirmatively elects to have the distribution transferred to a different IRA or a qualified plan or to receive it directly.

The written explanation provided by the plan administrator is required to explain that an automatic direct rollover will be made unless the participant elects otherwise. The plan administrator is also required to notify the participant in writing (as part of the general written explanation or separately) that the distribution may be transferred without cost to another IRA.

The Act amends the fiduciary rules of ERISA so that, in the case of an automatic direct rollover, the participant is treated as exercising control over the assets in the IRA upon the earlier of (1) the rollover of any portion of the assets to another IRA, or (2) one year after the automatic rollover.

The Act directs the Secretary of Labor to issue safe harbors under which the designation of an institution and investment of funds in accordance with the Act are deemed to satisfy the requirements of section 404(a) of ERISA. In addition, the Act authorizes and directs the Secretary of the Treasury and the Secretary of Labor to give consideration to providing special relief with respect to the use of low-cost individual retirement plans for purposes of the provision and for other uses that promote the preservation of tax-qualified retirement assets for retirement income purposes. The Act directs the Secretary of Labor to adopt final regulations implementing the Act not later than three years after June 7, 2001.

Effective Date

The provision applies to distributions that occur after the Department of Labor has adopted final regulations implementing the Act.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

<u>Section</u>	<u>Section Title</u>
658	CLARIFICATION OF TREATMENT OF CONTRIBUTIONS TO A MULTIEMPLOYER PLAN.

### Background

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, contributions are deductible for the taxable year of the employer in which the contributions are made. Under a special rule, an employer may be deemed to have made a contribution on the last day of the preceding taxable year if the contribution is on account of the preceding taxable year and is made not later than the time prescribed by law for filing the employer's income tax return for that taxable year (including extensions).

A change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item that involves the proper time for the inclusion of the item in income or taking of a deduction.

A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability. Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. A change in method of accounting also does not include a change in treatment resulting from a change in underlying facts.

### New Federal Law

The Act clarifies that a determination of whether contributions to multiemployer pension plans are on account of a prior year under section 404(a)(6) is not a method of accounting. Thus, any taxpayer that begins to deduct contributions to multiemployer plans as provided in section 404(a)(6) has not changed its method of accounting and is not subject to an adjustment under section 481. The Act is intended to respect, not disturb, the effect of the statute of limitations. The Act is not intended to permit, as of the end of the taxable year, aggregate deductions for contributions to a qualified plan in excess of the amounts actually contributed or deemed contributed to the plan by the taxpayer. The Secretary of the Treasury is authorized to promulgate regulations to clarify that, in the aggregate, no taxpayer will be permitted deductions in excess of amounts actually contributed to multiemployer plans, taking into account the provisions of section 404(a)(6).

No inference is intended regarding whether the determination of whether a contribution to a multiemployer pension plan on account of a prior year under section 404(a)(6) is a method of accounting prior to the effective date of the provision.

### Effective Date

The provision is effective after June 7, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
661	PENSION PLAN - MODIFICATION OF TIMING OF PLAN VALUATIONS.

#### Background

Under present law, plan valuations are generally required annually for plans subject to the minimum funding rules. Under proposed Treasury regulations, except as provided by the Commissioner, the valuation must be as of a date within the plan year to which the valuation refers or within the month prior to the beginning of that year.

#### New Federal Law (Sec. 412)

The Act incorporates into the statute the proposed regulation regarding the date of valuations. The Act also provides, as an exception to this general rule, that the valuation date with respect to a plan year may be any date within the immediately preceding plan year if, as of such date, plan assets are not less than 100% of the plan's current liability. Information determined as of such date is required to be adjusted actuarially, in accordance with Treasury regulations, to reflect significant differences in plan participants. A change in funding method to take advantage of the exception to the general rule may not be made unless, as of such date, plan assets are not less than 125% of the plan's current liability. The Secretary is directed to automatically approve changes in funding method to use a prior year valuation date if the change is within the first three years that the plan is eligible to make the change.

#### Effective Date

The provision is effective for plan years beginning after December 31, 2001.

#### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
662	ESOP DIVIDENDS MAY BE REINVESTED WITHOUT LOSS OF DIVIDEND DEDUCTION

#### Background

An employer is entitled to deduct certain dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by an employee stock ownership plan ("ESOP"). The deduction is allowed with respect to dividends that, in accordance with plan provisions, are (1) paid in cash directly to the plan participants or their beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) used to make payments on loans (including payments of interest as well as principal) that were used to acquire the employer securities (whether or not allocated to participants) with respect to which the dividend is paid.

The Secretary may disallow the deduction for any ESOP dividend if he determines that the dividend constitutes, in substance, an evasion of taxation (sec. 404(k)(5)).

### New Federal Law (Sec. 404)

In addition to the deductions permitted under present law for dividends paid with respect to employer securities that are held by an ESOP, an employer is entitled to deduct dividends that, at the election of plan participants or their beneficiaries, are (1) payable in cash directly to plan participants or beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) paid to the plan and reinvested in qualifying employer securities.

The Act permits the Secretary to disallow the deduction for any ESOP dividend if the Secretary determines that the dividend constitutes, in substance, the avoidance or evasion of taxation. This provision includes authority to disallow a deduction of unreasonable dividends.

For purposes of the section 404(k)(2)(A)(iii) reinvested dividends, a dividend paid on common stock that is primarily and regularly traded on an established securities market would be reasonable. In addition, for this purpose in the case of employers with no common stock (determined on a controlled group basis) that is primarily and regularly traded on an established securities market, the reasonableness of a dividend is determined by comparing the dividend rate on stock held by the ESOP with the dividend rate for common stock of comparable corporations whose stock is primarily and regularly traded on an established securities market. Whether a corporation is comparable is determined by comparing relevant corporate characteristics such as industry, corporate size, earnings, debt-equity structure and dividend history.

### Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
663	REPEAL TRANSITION RULE RELATING TO CERTAIN HIGHLY COMPENSATED EMPLOYEES

### Background

Under present law, for purposes of the rules relating to qualified plans, a highly compensated employee is generally defined as an employee, including self-employed individuals, who: (1) was a 5% owner of the employer at any time during the year or the preceding year or (2) either (a) had compensation for the preceding year in excess of \$85,000 (for 2001) or (b) at the election of the employer, had compensation in excess of \$85,000 for the preceding year and was in the top 20% of employees by compensation for such year.

Under a rule enacted in the Tax Reform Act of 1986, a special definition of highly compensated employee applies for purposes of the nondiscrimination rules relating to qualified cash or deferred arrangements ("section 401(k) plans") and matching contributions. This special definition applies to an employer incorporated on December 15, 1924, that meets certain specific requirements.

New Federal Law (Sec. 1114(c)(4) of the Tax Reform Act of 1986)

The Act repeals the special definition of highly compensated employee under the Tax Reform Act of 1986. Thus, the present-law definition applies.

Effective Date

The provision is effective for plan years beginning after December 31, 2001.

California Law

California law did not conform to the highly compensated employee rule enacted by the Tax Reform Act of 1986. Therefore, it is not necessary to repeal the special rule.

<u>Section</u>	<u>Section Title</u>
664	PENSION PLAN - EMPLOYEES OF TAX-EXEMPT ENTITIES.

Background

The Tax Reform Act of 1986 provided that nongovernmental tax-exempt employers were not permitted to maintain a qualified cash or deferred arrangement ("section 401(k) plan"). This prohibition was repealed, effective for years beginning after December 31, 1996, by the Small Business Job Protection Act of 1996.

Treasury regulations provide that, in applying the nondiscrimination rules to a section 401(k) plan (or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan), the employer may treat as excludable those employees of a tax-exempt entity who could not participate in the arrangement due to the prohibition on maintenance of a section 401(k) plan by such entities. Such employees may be disregarded only if more than 95% of the employees who could participate in the section 401(k) plan benefit under the plan for the plan year.

Tax-exempt charitable organizations may maintain a tax-sheltered annuity (a "section 403(b) annuity") that allows employees to make salary reduction contributions.

New Federal Law (Sec. 198)

The Treasury Department is directed to revise its regulations under section 410(b) to provide that employees of a tax-exempt charitable organization who are eligible to make salary reduction contributions under a section 403(b) annuity may be treated as excludable employees for purposes of testing a section 401(k) plan, or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan of the employer if (1) no employee of such tax-exempt entity is eligible to participate in the section 401(k) or 401(m) plan and (2) at least 95% of the employees who are not employees of the charitable employer are eligible to participate in such section 401(k) plan or section 401(m) plan.

The revised regulations are to be effective for years beginning after December 31, 1996.

### Effective Date

The provision is effective on June 7, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

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<u>Section</u>	<u>Section Title</u>
665	PENSION PLAN - TREATMENT OF EMPLOYER-PROVIDED RETIREMENT ADVICE.

### Background

Under present law, certain employer-provided fringe benefits are excludable from gross income and wages for employment tax purposes. These excludable fringe benefits include working condition fringe benefits and de minimis fringes. In general, a working condition fringe benefit is any property or services provided by an employer to an employee to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction as a business expense. A de minimis fringe benefit is any property or services provided by the employer the value of which, after taking into account the frequency with which similar fringes are provided, is so small as to make accounting for it unreasonable or administratively impracticable. In addition, if certain requirements are satisfied, up to \$5,250 annually of employer-provided educational assistance is excludable from gross income (sec. 127) and wages. This exclusion expires with respect to courses beginning after December 31, 2001. Education not excludable under section 127 may be excludable as a working condition fringe.

There is no specific exclusion under present law for employer-provided retirement planning services. However, such services may be excludable as employer-provided educational assistance or a fringe benefit.

### New Federal Law (Sec. 132)

Qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan is excludable from income and wages. The exclusion does not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified plan. "Qualified retirement planning services" are retirement planning advice and information. The exclusion is not limited to information regarding the qualified plan, and, thus, for example, applies to advice and information regarding retirement income planning for an individual and his or her spouse and how the employer's plan fits into the individual's overall retirement income plan. On the other hand, the exclusion does not apply to services that may be related to retirement planning, such as tax preparation, accounting, legal or brokerage services.

It is intended that the Act will clarify the treatment of retirement advice provided in a nondiscriminatory manner. It is intended that the Secretary, in determining the application of the exclusion to highly compensated employees, may permit employers to take into consideration employee circumstances other than compensation and position in providing advice to classifications of employees. Thus, for example, the Secretary may permit employers to limit certain advice to individuals nearing retirement age under the plan.

### Effective Date

The provision is effective with respect to years beginning after December 31, 2001.

### California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.

<u>Section</u>	<u>Section Title</u>
666	PENSION PLAN - REPEAL OF THE MULTIPLE USE TEST

### Background

Elective deferrals under a qualified cash or deferred arrangement ("section 401(k) plan") are subject to a special annual nondiscrimination test ("ADP test"). The ADP test compares the actual deferral percentages ("ADPs") of the highly compensated employee group and the nonhighly compensated employee group. The ADP for each group generally is the average of the deferral percentages separately calculated for the employees in the group who are eligible to make elective deferrals for all or a portion of the relevant plan year. Each eligible employee's deferral percentage generally is the employee's elective deferrals for the year divided by the employee's compensation for the year.

The plan generally satisfies the ADP test if the ADP of the highly compensated employee group for the current plan year is either (1) not more than 125% of the ADP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200% of the ADP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ADP of the nonhighly compensated employee group for the prior plan year.

Employer matching contributions and after-tax employee contributions under a defined contribution plan also is subject to a special annual nondiscrimination test ("ACP test"). The ACP test compares the actual deferral percentages ("ACPs") of the highly compensated employee group and the nonhighly compensated employee group. The ACP for each group generally is the average of the contribution percentages separately calculated for the employees in the group who are eligible to make after-tax employee contributions or who are eligible for an allocation of matching contributions for all or a portion of the relevant plan year. Each eligible employee's contribution percentage generally is the employee's aggregate after-tax employee contributions and matching contributions for the year divided by the employee's compensation for the year.

The plan generally satisfies the ACP test if the ACP of the highly compensated employee group for the current plan year is either (1) not more than 125% of the ACP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200% of the ACP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ACP of the nonhighly compensated employee group for the prior plan year.

For any year in which (1) at least one highly compensated employee is eligible to participate in an employer's plan or plans that are subject to both the ADP test and the ACP test, (2) the plan subject to the ADP test satisfies the ADP test but the ADP of the highly compensated employee group exceeds 125% of the ADP of the nonhighly compensated employee group, and (3) the plan subject to the ACP test satisfies the ACP test but the ACP of the highly compensated employee group exceeds 125% of the ACP of the nonhighly compensated employee group, an additional special nondiscrimination test ("multiple use test") applies to the elective deferrals, employer matching contributions, and after-tax employee contributions.



The plan or plans generally satisfy the multiple use test if the sum of the ADP and the ACP of the highly compensated employee group does not exceed the greater of (1) the sum of (A) 1.25 times the greater of the ADP or the ACP of the nonhighly compensated employee group, and (B) two percentage points plus (but not more than two times) the lesser of the ADP or the ACP of the nonhighly compensated employee group, or (2) the sum of (A) 1.25 times the lesser of the ADP or the ACP of the nonhighly compensated employee group, and (B) two percentage points plus (but not more than two times) the greater of the ADP or the ACP of the nonhighly compensated employee group.

New Federal Law (Sec. 401(m))

The provision repeals the multiple use test.

Effective Date

The provision is effective for years beginning after December 31, 2001.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to pension plans. California law has not conformed to the changes made to the IRC by the EGTRRA.